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**THE ECONOMIC CONSEQUENCES OF PEACE
FOR ISRAEL, THE PALESTINIANS, AND JORDAN**

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PREFACE

While economic issues have not been a driving force in the Arab-Israeli peace process in the past, they are sure to play a critically important role in the historic negotiations looming ahead. Across the wide Sinai expanse, Egypt and Israel have little to show in the way of economic ties, but their peace—“cold” as it is—still survives. The next phase of Middle East peace talks, however, will focus on Israelis, Palestinians and Jordanians who are already connected by a web of intricate and overlapping economic relationships. For them, economics and politics cannot be divorced.

If a secure and lasting peace is to be forged between Israel and its eastern neighbors, understanding the economic implications of potential peace options is a vital prerequisite. Indeed, any attempt to build a “warm” peace will require careful and expert attention paid to defining the relationships that will govern the flow of goods, people and capital between Israel, Jordan and the Palestinians.

In this Policy Paper, Patrick Clawson and Howard Rosen present the results of their year-long study into the economic consequences of peace. Bringing together decades of experience and a wealth of “new thinking” about the prospects for developing constructive economic relations between former adversaries, they lay out the implications of various peace scenarios highlighting the major issues and offering a framework for analysis. In outlining the economic dimensions of a potential peace process, the authors offer a

fresh and groundbreaking approach to the debate over Arab-Israeli peacemaking.

Once the procedural hurdles to direct talks between Arabs and Israelis are finally overcome, the next task for American policymakers will be to deal with negotiating the substantive issues essential to developing the contours of a peace settlement. Those are precisely the issues this Policy Paper tackles. In an effort to inform the policymaking process, The Washington Institute is pleased to publish this paper.

Barbi Weinberg
President
August 1991

EXECUTIVE SUMMARY

This study analyzes the economic effects of various scenarios, each a conceivable outcome of a peace process, without passing judgment on whether the economic benefits of any given policy should outweigh the political costs. The peace proposals are classified into four families, based on economic, rather than political, criteria. The four are:

Autarchy, or little movement of goods or labor between Jordan and Palestinian areas as well as between each and Israel;

Pre-1967, or free flows between Jordan and Palestinian areas but few flows with Israel;

Trade zone, or free movement of goods in the region without much flow of labor between Israel and other areas; and

Benelux, or free movement of goods and labor among Israel, Jordan and the Palestinian areas.

Autarchy would require that Palestinians raise billions of dollars to finance new infrastructure as well as create jobs for the Palestinians still working in Israel after the Gulf War. Yet, on the other hand, compared to no peace, autarchy would have limited effects on the Israeli economy, especially since Soviet

immigrants provide a ready source of alternative labor. Compared to the base case of no peace, autarchy would have few effects on Jordan.

The Benelux proposal could bring greater prosperity to the entire region. However, the advantages of Benelux will be small unless Israel and Jordan drop mercantilist policies which impede trade abroad and ease the maze of regulations which stifle entrepreneurs at home. In any event, the benefits of the Benelux proposal would be greater for the smaller economies, especially for the Palestinian economy.

The effects of the other two scenarios—trade zone and pre-1967—would fall somewhere in-between, but be closer, in the final analysis, to autarchy than to Benelux.

There is no reason to believe that the fact of immigration in and of itself would determine the form of a peace settlement, since the region has the resources to absorb all likely immigrants, Jewish as well as Palestinian. The arrival of Soviet immigrants will certainly have profound effects on the economy as well as on the region's politics, but the Soviet immigrants do not force Israel to seek more space on the West Bank.

Also, water issues also do not dictate one settlement or another. Despite the concerns in the region, sufficient water is available to handle any conceivable population growth in the next twenty years, if sensible policies are adopted.

Should the parties opt for relatively open, Benelux-style, economic relationships, the financing needs for peace would be small, though donors may be tempted to use the lure of aid to promote a settlement that neither side would particularly like. Autarchic, or relatively closed, arrangements on the other hand, would require over \$10 billion, if living standards in the Palestinian areas are not to drop further than they already have as a result of the *intifadah*. The availability of large-scale aid would have the effect of making autarchy more attractive. Aid in the form of the proposed Middle East Development Bank would be of more interest to Israel than to Arabs, because Israel, which needs financing to absorb Soviet immigrants, could more readily afford to pay market rates than could most Arab states.

The overall contribution of peace to the regional economy would be particularly welcome because the prospects for the next few years are troubled. Because of Soviet immigration,

Arab natural population growth, and poor prospects for Arab emigration to the Gulf, the regional labor force will grow at a rate that probably cannot be absorbed. Israel has the best prospects in the next few years, and therefore needs a peace bonus less than do the Arab areas; but in order to realize its potential, Israel will have to raise about \$5 billion a year from abroad over and above the normal flow of about \$5 billion. The outlook for Jordan is not good: incomes will probably have to fall sufficiently to allow Jordanians to displace the 150,000 foreigners working in the country now. The outlook for the Palestinian areas is extremely poor; there is a serious risk that living standards will fall back to the levels of twenty years ago.

In the interim before any peace settlement, some cooperative steps could be taken that would improve the welfare of Israelis, Palestinians and Jordanians without prejudging the character of the settlement. Most of these measures would bring greater benefit to Palestinians and Jordanians than to Israelis, for the simple reason that the Israeli economy is much larger and is therefore less affected by relations with its neighbors. This paper analyzes the pros and cons of seven steps: developing water policies to reduce Israeli depletion of the West Bank aquifer, storing more Jordan River water during the rainy winter months, facilitating foreign capital inflow into West Bank/Gaza, licensing freely West Bank/Gaza businesses, facilitating West Bank/Gaza exports, improving access for tourists, and permitting a more expansionary fiscal and monetary policy in West Bank/Gaza.

I SCENARIOS FOR PEACE

The Israeli-Palestinian peace process is not and should not be driven by economics. Nevertheless, politicians ought to be informed as to the economic consequences of their actions. The intent of this study throughout is to allow politicians to weigh economic factors in the scales when debating among alternative policies. Economic factors may set options apart, which otherwise may have been seen as being equally acceptable from a strictly political standpoint. It is our aim to remain as neutral as possible about the region's political future. We have therefore tried to avoid language that might seem to prejudice the political outcome.

Since the main aim of this study is to illuminate the economic aspects of the peace process, peace proposals are grouped here according to economic, rather than political, criteria. The key political issue is whether the West Bank and Gaza will be independent, associated with Jordan, or associated with Israel. What matters from an economic perspective is the degree to which the region's economies will be open or closed and the extent of their economic integration. A fully "open" economy entails an unimpeded and untaxed flow of goods, labor, and capital; in a fully "closed" economy there would be no flow of goods, labor, or capital.

Any given political solution does not in itself dictate a specific economic outcome. For instance, an "open" economy could accompany any political solution, i.e. a fully independent Palestinian state could have no barriers to economic relations with Israel or Jordan. On the other hand, a "closed" economy could be practiced just as well under an

autonomous West Bank/Gaza that remains under Israeli rule as under an independent Palestinian state. Admittedly, some combinations of political solutions and economic outcomes seem more likely than others. It is especially hard, for instance, to see how a closed economy could be compatible with absorption of the West Bank and Gaza into Israel; even so, the winter of 1990-91 saw calls by some in the Israeli right for breaking the economic links between Israel and the occupied West Bank/Gaza, as well as between West Bank/Gaza and Jordan, while retaining West Bank/Gaza under Israeli rule.

We do **not** propose in this study to analyze different proposals for a political settlement. We have endeavored to keep our analysis independent of assumptions about the character of any specific political settlement; our aim is to comment solely on the critical economic issues facing the parties in the region.

We have found in our discussions with political analysts and policymakers a wide range of assumptions about what future economic relations will be. Some partisans of Palestinian independence reject out of hand any economic ties to Israel, while others insist just as firmly that close economic ties are inevitable. We found a similar diversity among supporters of other political solutions. This suggests that the issue of the region's future economic ties has not yet become frozen into hard and fast positions, making a study of the advantages and costs of different proposals timely and perhaps necessary.

There are many possible combinations of economic opening and closure among Israel, West Bank/Gaza, and Jordan. Based on numerous interviews, research and advice we have gathered from close students of the politics of the peace process, this study concentrates on four groups of options:

Autarchy: There would be *little flow of goods, labor, or capital across either the Israeli or the Jordanian border*. In this scenario, the West Bank and Gaza would be as economically independent as possible from their neighbors. Politically, this might mean West Bank/Gaza would be cut off by the Israeli authorities from both Israel and Jordan, or it could mean an independent Palestine not friendly to either Israel or Jordan.

Pre-1967: The situation would return to the status that was in place before the June 1967 war (with the difference that the Gaza Strip would now be open to trade with Jordan). There would be *little flow of goods or labor across the Israeli border*, while

there would be an essentially *free flow between Jordan and Palestinian areas.*

Trade zone: *Goods would flow freely across the region, but there would be little flow of labor or capital across the Israeli border.* Jordan and West Bank/Gaza would, on the other hand, probably have a relatively free flow of labor and capital between them.

Benelux: Like the relations among Belgium, Netherlands, and Luxembourg, *the region would have a fully free flow of goods, labor, and capital.* There would at least be a free trade zone if not a full customs union, co-ordination of monetary policy if not a monetary union, and a variety of joint institutions would manage common resources.

In order to determine what difference the peace process makes, the four scenarios must be compared with a base case. The relevant base case is not what prevails now, but what would prevail in the absence of peace. The distinction is important, because the most likely forecast for the region's economies in the absence of peace is quite different from what we see now. To summarize what is developed at length below, Israel has good growth prospects for the 1990s, Jordan's economic future is troubled, and West Bank/Gaza have bleak economic prospects.

The body of this paper is organized as follows: Chapter II presents the existing economic setting in Israel, the West Bank and Gaza, and Jordan, focusing on resettlement and immigration, employment and income growth, management of trade and common resources, and the financial implications of peace. Chapter III briefly discusses the question of water. In Chapter IV we analyze the Autarchy and Pre-1967 options and in Chapter V we analyze the Benelux and Free Trade Zone options, as described above. Finally, several interim economic steps which might enhance the political process are explored in Chapter VI.

II THE ECONOMIC SETTING

THE ISRAELI ECONOMY

Population and Housing

The population of Israel proper stands at roughly 4.5 million, three-quarters of whom are Jews, the rest being Muslim, Christian and Druze. In 1990, the Jewish population increased by 187,000 as a result of immigration and by an additional 47,000 due to an increased birthrate relative to deaths. Jewish emigration from the USSR has soared with the recent lifting of restrictions, coupled with extremely poor economic conditions and heightened fears of rising anti-semitism in the Soviet Union.¹ While Soviet immigration slowed to 86,000 during the first six months of 1991, the Israeli government projects that one million immigrants might arrive between 1990 and 1994, which would constitute a 20 percent increase in domestic population and, in fact, equal half the total number of all immigrants into Israel during the country's first four decades of existence. It is, however, still

¹Soviet-Jewish emigration to Israel is abetted by the fact that Israel guarantees citizenship to any Jewish immigrant, something which other countries are loath to do. The United States currently limits the number of Soviet Jews it allows to enter the country under refugee status to approximately 60,000 people per year. Political reform in Eastern Europe has also placed increasing economic and demographic pressure on several Western European countries, leading them to be more restrictive concerning Soviet immigration as well.

unclear if this projection will be realized. The most important variable in this estimation is the domestic political situation in the Soviet Union, such as possible new emigration restrictions, increasing economic hardship, or rising anti-semitism. At the same time, difficulties involved in resettling new immigrants in Israel could discourage migration there.

The demographic characteristics of the Soviet Jews are quite different from those of previous large migrations in Israel. For the most part, Soviet immigrants are older, more highly-educated and have work experience. It is estimated that approximately 40 percent of the Soviet immigrants in 1990 have had professional training as engineers, doctors or post-primary teachers in the Soviet Union compared to less than ten percent of the current Israeli resident population. The current Israeli workforce has a significantly higher concentration of administrative, managerial and blue collar workers than does the body of recent Soviet immigrants (though there are many doubts concerning the comparability of the skills of Soviet immigrants to those of their Western-educated Israeli counterparts).²

On a political level, some have tried to link the massive influx of Soviet Jews to Israel's policies towards the West Bank and Gaza. On more than one occasion Prime Minister Shamir and others in his cabinet have implied that Israel "needs" the West Bank and Gaza in order to provide housing for the prospective new citizens. In relative terms, both compared with the current population density of Israel, and compared against other countries, there is nothing to suggest that Israel would actually require additional land to absorb the new immigrants. Israel's population density in 1988 was 205 persons per square kilometer, compared to 327 in Japan and 220 in newly-unified Germany.³ These immigrants could be absorbed by some of the districts in Israel with lower population density (Israeli population density varies from 38 to 6000 per square kilometers).

²See Bank of Israel Report, "Economic Policy in a Period of Immigration," Jerusalem, May 1990.

³Adding 1 million people to the population of Israel would increase the population density for the entire country to 251.6 people per sq. km.

Even so, the large influx of Soviet immigrants will place considerable pressure on both public and private financing requirements. The public financing needed would be the smaller part by far. A recent report by the Bank of Israel forecast that the budget deficit, which has recently been declining, could, despite the immigration, continue on its downward path from 8.0 percent of GNP in 1989 to 6.0 percent in 1991; the report optimistically forecasts a budget surplus by 1995.⁴ This surprising result stems from three factors. First, tax revenues will rise, thanks to the economic growth resulting from immigration. Second, defense expenditures, the largest share of expenses, do not rise with population. Third, the immigrants do not use government services intensely after their initial absorption, which requires expenditure on Hebrew language training, grants for living expenses, subsidies for job creation, and the like. Indeed, the immigrants tend to have fewer children, thus saving the state so much on education costs that government spending per person will fall within a few years. Perhaps the Bank of Israel is overly optimistic, but the general point remains that the significant financial needs created by immigration are for job creation and housing, not for government spending as such.

Massive amounts of capital will be needed in order to build the necessary housing and create jobs for the Soviet immigrants. The Bank of Israel suggests that the economy will need \$80 billion for investment in 1991-95 at 1989 prices. (An earlier Bank report spoke of \$85 billion which was divided between \$20 billion for investment in housing and \$65 billion to create 600,000 jobs over the next five years for 450,000 Soviet immigrants and 150,000 new Israeli entrants into the labor force).⁵ Most of this additional capital requirement is expected to be raised from Israelis' domestic savings and from existing flows of aid from governments and individuals abroad. Approximately \$25 billion will need to be financed through foreign borrowing. The Israeli government hopes to raise much of these foreign funds from export credit agencies such

⁴Research Department, Bank of Israel, "One Million Immigrants—an Absorption Program," Jerusalem, April 1991.

⁵Research Department, Bank of Israel, "Economic Policy in a Period of Immigration," Jerusalem, May 1990.

as the U.S. Export-Import Bank, as well as through private commercial loans guaranteed in part by the U.S. government and loans from private commercial sources. Much of the foreign borrowing for the investment will be in the name of the Israeli government, but the cost of repaying the debt will be borne by the firms which ultimately receive the funds on-lent by the Israeli government. (Some of these firms will be privately-owned and some will be public enterprises).

Israel's construction industry is poorly placed to meet the housing demands of the immigrants, having been in secular decline since 1975. The industry has also been hard hit by the Palestinian uprising, or *intifadah*, which has resulted in high rates of worker absenteeism since December 1987. The potential increased demand for housing from the influx of Soviet immigrants raises several additional problems for the construction industry. First of all, it is still unclear exactly how many immigrants will be coming to Israel, and over what time period. Still feeling the after-shocks of over-supplying the housing market in the 1970s, during a previous wave of Soviet immigration, builders are looking to reduce their risk of trying to meet an unknown demand for housing. Further constraints on the housing industry are an unsophisticated capital market and public policies which restrict and tightly regulate land ownership.

Debate continues in Israel over how to adjust to this potential one-time jump in the demand for housing. If the domestic housing industry attempts to meet the demand by itself, it will require a significant increase in workers, equipment and capital. If on the other hand, this immigration is seen as a one-time phenomenon lasting only five years and levelling off shortly thereafter, it may be more appropriate to use temporary housing for the immigrants' immediate housing needs and import pre-fabricated housing, as well as to rely on skilled foreign workers.⁶

The structure of the Israeli housing market, greatly influenced by the financial market, is predominantly geared toward private ownership of apartments, leaving only a small and informal rental market. Demand for rental apartments has soared, in part because the government has provided new

⁶The industry has apparently begun to follow this strategy and has begun to assemble pre-fabricated housing throughout the country.

New Residential Dwellings Number of Units Completed



immigrants with a rent subsidy; the housing crunch has also left many young Israelis competing with new immigrants for scarce housing. As a result, "tent cities" began popping up throughout the country during 1990, though more as a form of protest than as a result of homelessness. The government has been slow to respond, and this initial squeeze on the housing market appears to be a precursor of what is to come.

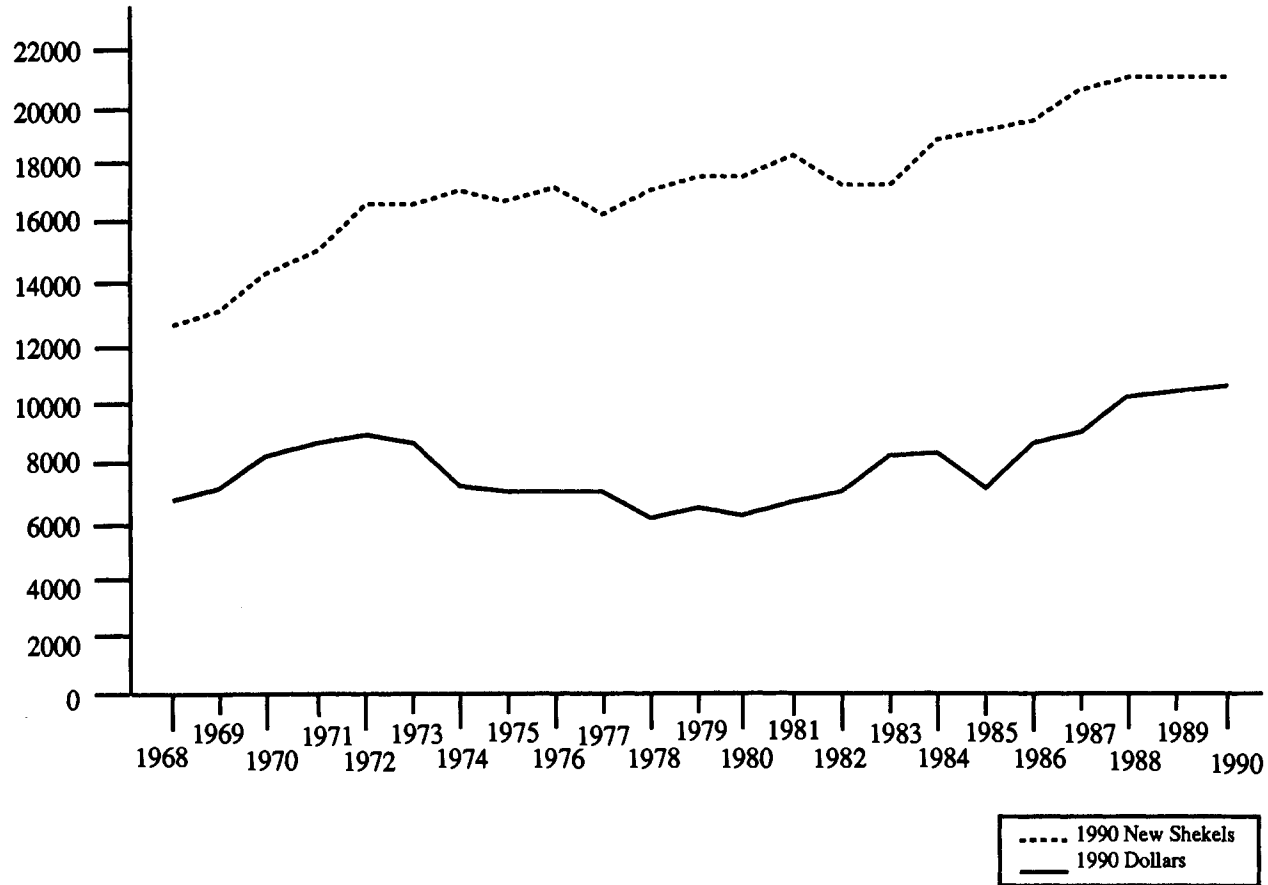
The government has taken several limited steps to liberalize the housing market and entice builders to begin meeting the housing shortage. The construction industry has been slow to respond to these changes, most likely because trade unions are holding out for more government guarantees and financial incentives. Imports of temporary pre-fabricated housing have been slowed due to debate over hiring foreign workers to assemble the structures. Housing construction did pick up by mid-1991, and the construction time for a public apartment building now approaches twelve months instead of the historical twenty-five. Nevertheless, the housing shortage is expected by the Housing Ministry to worsen until mid-1992.

Income and Employment

After the 1973 war, Israel went through a troubling decade during which per capita real incomes fell and then stagnated at the lower level. Domestic output (GDP) per person rose, but so did the burden of servicing foreign debt, resulting in a decline of overall per capita income. In the mid- and late-1980s, Israel enjoyed increasing income and reasonably full employment, though at first the growth was "hothouse artificial," fed by an increasing foreign debt and a yawning budget deficit financed by rampant inflation. Since the economic reforms of 1985-86, growth has been somewhat slower but more sustainable. As the prospects for the economy have stabilized, Israel's currency has strengthened vis-a-vis the U.S. dollar. The gains of the 1980s and the problems of the 1970s are both rather dramatic in U.S. dollars, much more so than in shekels. Per capita income in 1990 in U.S. dollars was \$10,000, compared to about \$8,000 in

Israel

Per Capita GNP



both 1985 and 1970 (all data in 1990 dollars).⁷

Paradoxically, unemployment moved in the opposite direction. In the 1970s, the number of unemployed averaged well under 50,000, despite low income growth. Unemployment increased in the first seven years of the 1980s, despite improved income growth. The situation has deteriorated further since 1988: The number without work shot up from 83,000 in June 1988 to 155,000 in June 1990. At this level, the number of unemployed Israelis exceeded the number of Palestinians who commuted to work in Israel before the Gulf War.⁸ Unemployment is increasing with immigration, though immigrants typically spend the first six to twelve months in language courses before joining the workforce proper. Some estimate that unemployment could reach as high as 20 percent if policies are not changed and immigration rebounds to the late-1990 levels.

Trade Flows

Israeli merchandise exports in 1990 were \$8.5 billion and imports were \$10.5 billion, excluding diamonds (which, because of their high value, comprise approximately 30 percent of Israeli exports, 20 percent of imports, and, in all, are the single largest element in Israeli trade). Together, Israel's exports and imports comprise almost half of the country's GNP. This heavy dependence on trade comes from the fact that, like many small countries, Israel must import most of its industry's raw material and primary input needs, accounting for another 50 percent of imports. Of the remaining imports, 18 percent are

⁷Unless otherwise noted, data cited are authors' estimates based on data from the Central Bank of Jordan and the Israeli Central Bureau of Statistics. Some data have been drawn from the International Monetary Fund's International Financial Statistics. The data should be seen as approximate, because it is conceptually hard to correct for the distortions that affected these economies in the 1970s and 1980s (raging inflation in Israel, overvalued exchange rates in Jordan). A text of this study, including detailed notes on methodology and sources, is available from the authors.

⁸The Israeli unemployment rate in June 1990 was 8.6 percent, with the labor force being 1.80 million people.

capital goods and equipment; only 12 percent of imports are finished consumer goods.

Israel places great emphasis on exports, in large part to help finance its dependence on imported raw material and production input, and in order to acquire foreign currency to help meet its external debt payments. Almost two-thirds of Israeli exports are industrial products, and approximately five percent of exports are agricultural products. The geographic distribution of Israeli exports is split almost evenly between the United States and countries in the European Community, with each market accounting for one-third of Israeli exports. The remaining third of Israeli exports is divided almost equally between East Asia and the rest of the world.

Israeli trade with the West Bank and Gaza accounts for only 3 percent of all its imports and 16 percent of total Israeli exports; indeed, excluding goods imported into Israel and re-exported to West Bank/Gaza, those areas absorb less than 10 percent of Israel's exports. By contrast, Israel dominates Palestinian trade flows, providing almost all imports into the West Bank and Gaza and purchasing 80 percent of their exports.⁹

As part of the *intifadah*, Palestinians in the West Bank and Gaza have been following a "buy Palestinian" policy, favoring the purchase of locally made products over those made in Israel. Given the substantial degree of integration into the Israeli economy, and many of the factors mentioned above, this policy has not resulted in a complete embargo against all Israeli products.

An important barrier blocking Israeli exports to the rest of the world is the Arab boycott, which began in 1948 on the establishment of the State of Israel. As a direct result of the boycott, Arab nations refuse to buy products produced in Israel or which have any discernible Israeli input. This has forced Israel to look beyond its large proximate market and develop secure markets in Europe and the United States, in spite of the additional transportation costs. In addition to its direct effect on the sale of Israeli products, the boycott extends to discriminate against firms of any nationality doing business with Israel or with identifiable Jewish owners, thereby inhibiting a wide

⁹The last available trade data are from 1987, prior to the outbreak of the *intifadah*.

range of commercial relationships, most importantly foreign investment in Israel. The recent news of a possible removal of the Arab boycott should help attract much needed foreign capital and possibly open some new export markets for Israeli products.

THE ECONOMY OF WEST BANK AND GAZA

Population

The Israeli Central Bureau of Statistics estimates Palestinian population of the West Bank and Gaza in 1989 to be 1.5 million people¹⁰, though the trend in both growth rates has been rising. Between 1977 and 1988, population growth averaged 2.3 percent per year in the West Bank and 3.2 percent per year in Gaza. Palestinian population growth is by and large dominated by two factors: relatively high birth rates and net emigration.

The average Palestinian birth rate in the West Bank and Gaza is approximately double that of the Israeli population, providing a natural source for accelerating population growth in those areas. Crude estimates suggest that over the next several years the Palestinian population can be expected to grow by at least 50,000 persons per year, or three percent of the total population, due to natural increase alone. This is twice the rate of current Israeli population growth (not counting immigration).

There is virtually no Palestinian immigration into West Bank/Gaza, in large part due to security restrictions undertaken by Israeli authorities.¹¹ On the other hand, there has been considerable emigration over the years, particularly from the West Bank, for both political and economic reasons.

¹⁰Data collection in the West Bank and Gaza has never been easy, and the difficulties of counting have increased since the start of the *intifadah*, in December 1987. Any data concerning Palestinians since then should be interpreted with special care. Because of the practical difficulties posed by Israeli data which includes East Jerusalem in Israel, the data presented here for Gaza/West Bank exclude East Jerusalem unless otherwise noted.

¹¹The Israeli authorities in 1991 have reportedly offered, however, to permit immigration of Palestinians who invest heavily in West Bank/Gaza.

During the nearly two decades during which the West Bank was under Jordanian rule, emigration equalled two-thirds of the population growth. Contrary to the myth that the Israeli occupation authorities encouraged or forced emigration, emigration in fact slowed after 1967; while a quarter of a million people left in the 15-year period from the mid-1950s to 1967, just 200,000 have emigrated in the twenty-three year period since 1968. The opportunities offered by the Gulf oil boom were more than offset by the attraction of work inside Israel. The population of the West Bank, which had grown at a rate of 0.9 percent per annum under Jordanian rule, rose to 1.8 percent from 1968 through 1982 and 3.0 percent thereafter, when emigration was impeded by new Jordanian rules and fewer opportunities in the Gulf. Much of the net migration during this period can be attributed to increased economic opportunities outside the West Bank/Gaza, both in the Persian Gulf region, and abroad in Europe and the United States, and poor economic conditions at home.¹²

Remittances from the large number of Palestinians who took jobs in the Persian Gulf and other countries abroad over the years have contributed to the economy of the West Bank and Gaza. There are numerous estimates as to how many of these people would consider returning to the area if political and economic conditions improved. Higher estimates suggest that as many as 650,000-750,000 Palestinians might want to return to the West Bank and Gaza after some kind of political settlement had been reached.¹³ It is difficult to confirm this number, but a rough calculation suggests that at least 650,000 Palestinians left the West Bank and Gaza between the mid-1950s and 1987.¹⁴ Not every person who left West Bank/Gaza will be inclined to return under favorable political and economic conditions, but on the other hand, many of those

¹²See Gabriel and Sabatello, "Palestinian Migration from the West Bank and Gaza", *Economic Development and Social Change*, 1986.

¹³George Abed, *The Economic Viability of a Palestinian State* (Washington: Institute for Palestine Studies, 1990).

¹⁴Emigration is estimated at 250,000 from mid-1950s to 1967, 200,000 after the 1967 war and 200,000 since 1968.

who did leave have subsequently acquired families that would probably accompany them on their return.

The extent of immigration is likely to depend primarily on politics, not on economics. The Israeli government does not welcome the prospect of significant numbers of Palestinians returning to the West Bank and Gaza, and for security reasons would likely take steps to restrict such an occurrence. (As discussed below, it is fair to expect that many jobs would exist for returning Palestinians under freer economic arrangements).

In addition to the Arab population, the territories also have a significant Jewish population. A 1991 State Department report estimates that approximately 200,000 Israelis currently live beyond the "Green Line," or the pre-1967 borders.¹⁵ This estimate includes roughly 120,000 Israelis living in East Jerusalem, annexed by the Israeli government, and in new "bedroom communities" surrounding Jerusalem, such as East Talpiot, Gilo, Ramot and Ramat Eshkol. The other 80,000 Israelis live in 150 residential communities in the West Bank and in 15 settlements in Gaza; probably half of the former are concentrated in the greater Jerusalem metropolitan area, which includes Ma'aleh Adumim, Kiryat Araba, Givat Ze'ev, Efrat and the Gush Etzion bloc and which in 1986 accounted for 30,000 Israelis. With the growth in settlement activity over the past few years, it can be estimated that probably only about 50,000 Israelis live outside a ten mile radius of Jerusalem.¹⁶

The debate over the number of Israelis living in the West Bank and Gaza has gained attention with the influx of Soviet immigrants and Israeli requests for U.S. loan guarantees to help provide additional housing for them. It is important to keep in mind that although the number of Israelis in West Bank/Gaza is growing, their potential relocation does not serve as an insurmountable economic barrier. In fact, if a political settlement should result in having to resettle either some or all of the Israelis living in West Bank/Gaza, that challenge would

¹⁵U.S. Department of State, "Israeli Settlement in the Occupied Territories," mimeo, processed, March 1991.

¹⁶One State Department source estimates that the number of Israeli residents of the West Bank/Gaza has been increasing by about 20,000 a year.

pale compared to meeting the housing and employment requirements of a prospective one million Soviet immigrants over the next five years. Based on the 1991 State Department report, such resettlement would probably affect only about 100,000 people, requiring some 25,000 units, a small number in comparison to the housing needs facing the Israeli economy as a whole.

Income and Employment

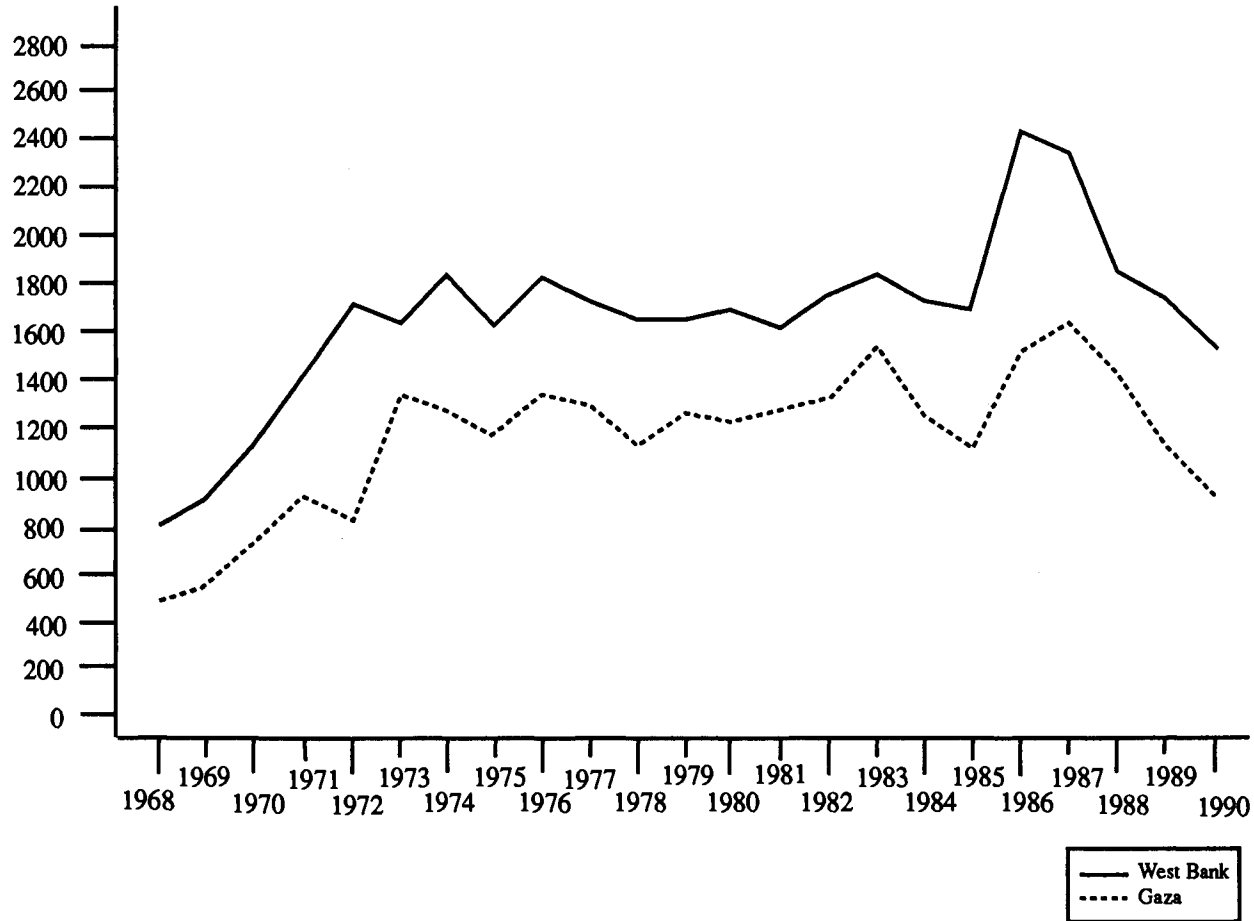
The West Bank and Gaza experienced rapid employment and income growth in the decade following the 1967 Six-Day War. Both local output and income from work in Israel rose, with per capita income rising from \$700 in 1968 to \$1,500 in 1975 (in 1990 dollars)¹⁷. In the next decade, however, between 1977 and 1987, income growth slowed—precisely as the growth rate rose in Jordan, which serves as the economic reference point for many in the West Bank. Per capita income in 1987 was \$2,000 in 1990 dollars.

Agriculture, construction and the public sector each constitute 20 percent of the Palestinian economy. The service sector comprises almost 30 percent of the West Bank and Gaza economies, and industry accounts for the remaining less than 10 percent. Taken together, the overall size of the West Bank and Gaza economies together is quite small, valued at approximately \$2 billion (figures are necessarily imprecise because the *intifadah* has impeded data collection). Roughly 40,000 Palestinians are employed in the agricultural sector, whose main products are olives, livestock (including meat, milk and eggs), citrus and vegetables. Only 20,000 Palestinians are employed in industry within the West Bank and Gaza.

Since the 1970s, increased integration into the Israeli economy has created more jobs for Palestinians in Israel than in the West Bank and Gaza. Immediately prior to the outbreak of the *intifadah*, approximately 110,000 workers, or one-third of the Palestinian workforce, found jobs in Israel. Thus, in effect,

¹⁷An important element in West Bank output is the olive crop, which is much larger in even calendar years than in odd years. The data cited here generally use the lower (odd) years; however, data for the war year of 1967 are not used.

The West Bank and Gaza
Per Capita GNP (1990 U.S. Dollars)



the principal “export” of the West Bank and Gaza was Palestinian labor.

Even so, the years immediately before the 1987 outbreak of the *intifadah* were not good economically. Indeed, Ze’ev Schiff and Ehud Yaari argue that “the *intifadah* began not as a national uprising to throw off the yoke of foreign domination but as rebellion of the poor.”¹⁸ If so, it was a perverse rebellion which accomplished the exact opposite of its aims, depressing incomes sharply—the best guess is that by 1990, per capita income had dropped 35 percent below its 1987 level, to about \$1,300.

The *intifadah*’s effects on West Bank/Gaza employment were far less dramatic. According to Israeli data, from the third quarter of 1987—before the *intifadah*—to the fourth quarter of 1989, employment fell only two percent, from 277,000 to 272,000.¹⁹ However, there was a precipitous drop in the average number of hours worked per week, so that the total number of hours worked by the residents of West Bank/Gaza fell by 19.2 percent. In other words, many Palestinians went from full to partial employment, unable to work on the days when political strife closed factories or blocked transport. In 1988, the most recent year for which such data are available, 90,000 Palestinians were listed as working on a part-time basis or “temporarily absent from work.”²⁰ Some of this is voluntary (e.g., at any moment, some workers are absent due to sickness), but the more normal level would be the 22,000 in those categories in 1987, not the 90,000 in 1988.

The evidence on full-fledged open unemployment is limited. Israeli data understate both Palestinian employment and unemployment. Our estimate—and it is certainly crude—is that in 1987 unemployment in West Bank/Gaza was at least

¹⁸Ze’ev Schiff and Ehud Yaari, *Intifada* (New York: Simon and Schuster, 1990), p. 79.

¹⁹Unpublished data from the Israeli Central Bureau of Statistics; details available from the authors.

²⁰Central Bureau of Statistics, *Statistical Abstract of Israel 1989*, p. 716.

25,000 compared with a labor force of at least 350,000.²¹ Since the start of the *intifadah*, employment has stagnated or fallen; the conventional wisdom is that at least 50,000 Palestinians lost their jobs in Israel during the Gulf War, and many have not been re-employed since the war's end. Meanwhile, population growth keeps adding more to the pool of those looking for work. At a conservative estimate, the unemployed in mid-1991 numbered some 100,000—25 percent of the labor force. Underemployment has increased much more, accelerating the above-noted shift towards part-time work.

Trade Flows

During the twenty years of Israeli rule, the West Bank and Gazan economies have become increasingly dependent on Israel for trade. In 1970, 46 percent of the total exports from West Bank/Gaza went to Israel, while 38 percent went to or through Jordan on their way to other Arab countries. By 1987 Israel was the dominant market for exports from the West Bank and Gaza, absorbing 79 percent of their total exports, while the Jordanian share fell to just 20 percent. At the same time, exports declined in importance in the combined GDP of West Bank/Gaza, falling from 29 to 21 percent of GDP. Of the imports into West Bank/Gaza, the share coming from Israel rose from an already hefty 84 percent in 1970 to 91 percent by 1987. Over the same period, imports fell from 73 percent to 57 percent of the combined GDP of West Bank and Gaza.

Palestinian exports to Jordan are more highly concentrated in agricultural goods. More than half of all Palestinian agricultural exports go to Jordan, including 25 percent of the West Bank citrus crop, 20 percent of the fruit crop and just under 15 percent of the vegetable crop. Prior to the outbreak of the *intifadah*, Israel purchased almost three-fourths of the industrial products exported from the West Bank and Gaza.

Palestinian exports suffer from the current political status of West Bank/Gaza, under which the Israeli government, primarily through the Civil Administration, practices complete authority over all economic activity. Israeli products

²¹Schiff and Yaari, *Intifada*, p. 91, estimate that 15,000 Palestinian college graduates were unemployed when the *intifadah* started. That would make the estimate here (25,000 of all education groups unemployed) seem very conservative.

are free to enter the West Bank and Gaza, while goods from West Bank/Gaza are subject to Israeli regulations, which include a host of openly protectionist requirements designed to shield Israeli producers from Palestinian competition, as well as some regulations that are imposed for security purposes. The Israeli government has never taken a public stand against industrialization in the West Bank and Gaza, but various ministries have used their licensing and regulatory authorities to block Palestinian competition with Israeli products. (Interestingly, most of the opposition to industrialization has come from civilian ministries, not from the Defense Ministry or from the territories' Civil Administration).

Another important inhibition to Palestinian trade is the fact that there are no active land or water ports within the West Bank and Gaza. Palestinian products are either traded through Israel—via Haifa, Ashdod or Lod—or across the Allenby and Damya bridges into Jordan, under Israel's "open bridges" policy. There are no official checkpoints through which goods must pass in order to enter into Israel, although there are numerous security measures which serve similar purposes.

Once in Israel, Palestinian goods must compete against Israeli products for access to export markets, primarily because of their dependence on Israeli ports. Moreover, agricultural exports are highly regulated and dominated by several strong "boards," which serve as clearinghouses for exports. Because of the small scale of operations, the entire process is rather closed and held in the hands of a few. Over the years there have been numerous complaints by Palestinians that their products were left to rot, while Israeli produce was exported in their places. Since 1988, Palestinian producers have been able to ship citrus to Europe, without the approval of the Citrus Board or the Agrexco export monopoly. This led to an increase in trade, but complaints persist. The situation may change with the abolition of the Israeli Citrus Board in preparation for the economic integration of 1992.

If Palestinian products are able to pass these numerous hurdles within Israel, they must then find a way of coping with the web of protectionist measures in importing countries, similar to those facing Israeli products. Ironically, the Arab boycott against products either made in Israel or embodying some Israeli input hits hard at Palestinian products as well. In order to pass the boycott's muster, products from the West

Bank/Gaza must be certified as wholly devoid of Israeli inputs or as having been imported via Israeli ports (including not being produced on machinery from or imported via Israel). This has proven difficult: given the extent of Palestinian economic integration into the Israeli economy, at least up until the outbreak of the *intifadah*, it is difficult to find Palestinian products that do not have some kind of Israeli input.

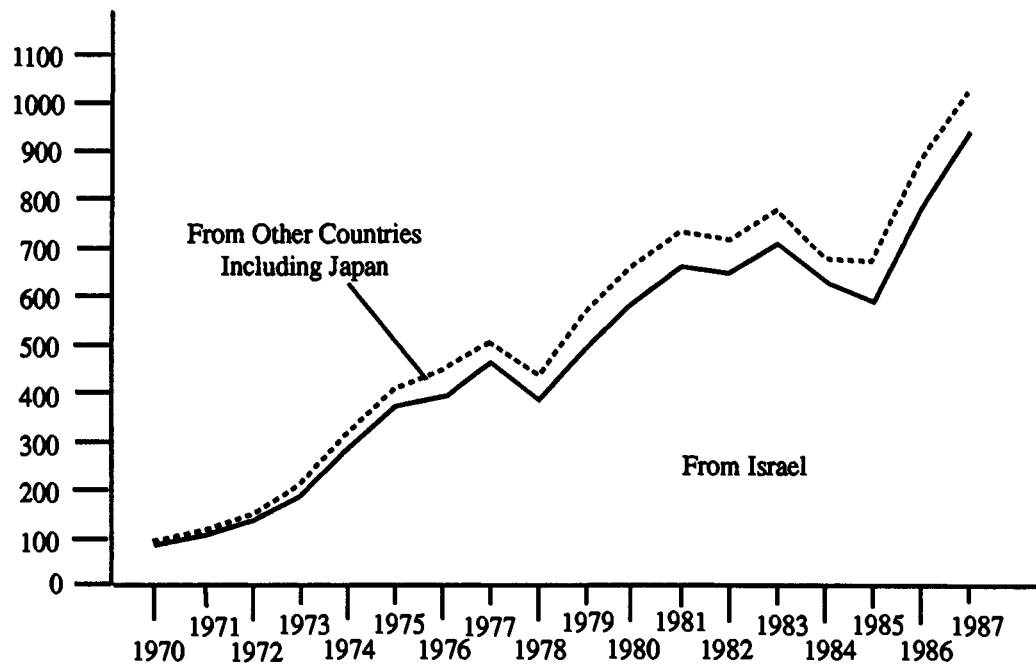
Jordanian policies toward imports from the West Bank and Gaza are quite restrictive. For example, it is extremely difficult to import into Jordan products by Palestinian firms established after 1967. In addition, Jordan insists that all raw material imports be procured through Jordanian, and not Israeli, ports. Together with other intentional and nonintentional restrictions, Jordan has through these practices denied Palestinian products access to its natural and geographically close market.

Palestinian trade prospects are further handicapped by the non-renewable natural resource and raw material base of the area and the small size of the domestic market in the West Bank and Gaza. Israeli security measures make it difficult to import raw material from Jordan, thereby imposing another handicap on Palestinian exports. In addition the local infrastructure is inadequate, investment funds are extremely limited, the marketing network is unsophisticated and the necessary banking functions are virtually non-existent.

Moshe Arens, the Israeli Minister of Defense, has been attempting to encourage the pace of industrialization in the West Bank and Gaza. In April 1991, the Israeli Ministries of Defense, Economics and Planning issued a tax reform proposal that would grant tax exemptions for the establishment of new plants in the Gaza strip. The tax break proposal closely follows the recommendations of the Sadan Commission—appointed by Moshe Arens to explore ways to revitalize the economies of the West Bank and Gaza. In addition, the Civil Administration announced in May 1991 the granting of 31 permits to establish new factories in the West Bank.

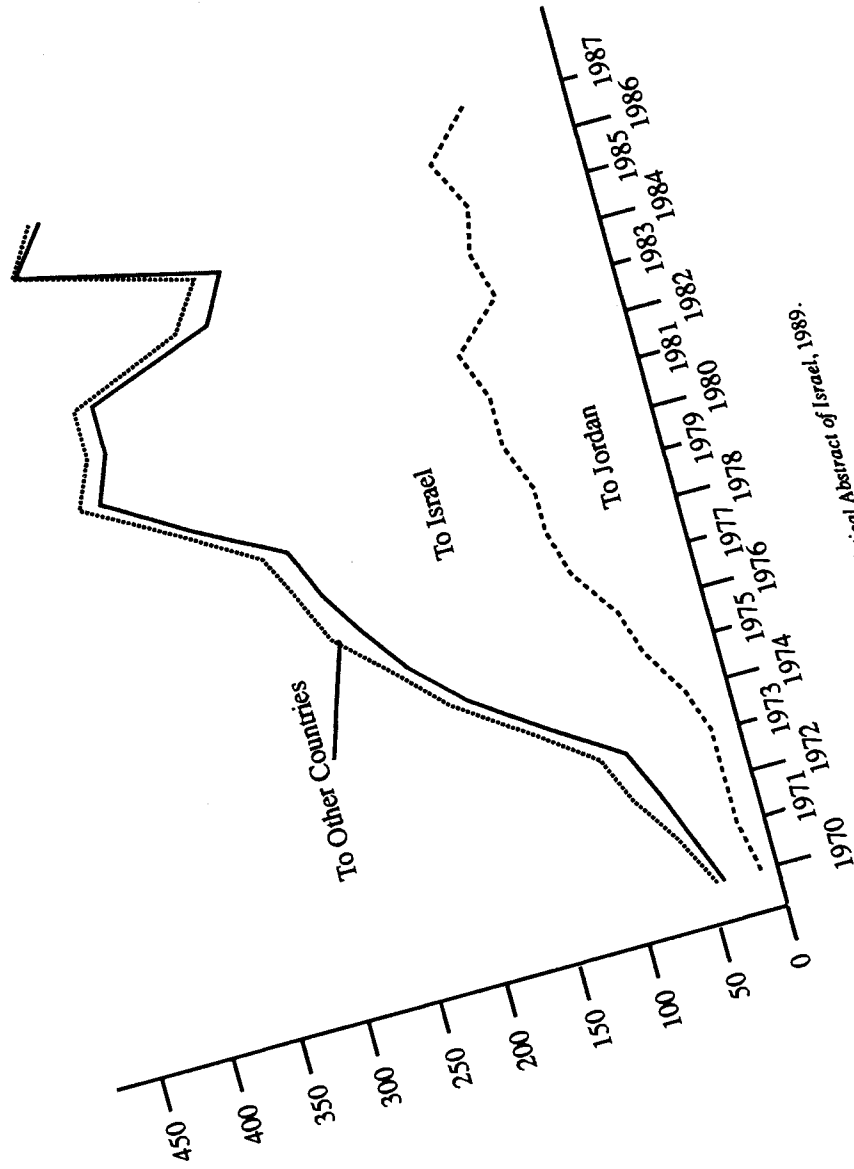
It is still too early to tell whether Arens' proposals constitute a clear reversal of the prevailing government policy to discourage West Bank and Gazan industrialization that directly competes with Israeli manufacturers. The tax break reforms, though proposed, have yet to be endorsed as official government policy, mainly due to opposition from within the

West Bank and Gazan Imports
1970-1987
(Millions of U.S. Dollars)



Source: Israel Central Bureau of Statistics, *Statistical Abstract of Israel*, 1989.

West Bank and Gazan Exports
 1970-1987
 (Millions of U.S. Dollars)



Source: Israel Central Bureau of Statistics, Statistical Abstract of Israel, 1989.

Israeli cabinet. Nevertheless, Arens' active involvement is an encouraging sign that the Israeli government will be less averse to industrial growth in the territories than it has been in the past.

THE JORDANIAN ECONOMY

Population

As of 1990, Jordan's population stood at 3.12 million. The available data on the Jordanian population are complicated by the fact that a large number of Palestinians carry Jordanian passports but do not live there. The two largest such groups are: (1) the residents of the West Bank who until 1988 could automatically receive a Jordanian passport and (2) the vast majority of the Palestinians in the Persian Gulf states. The latter group was roughly 900,000 in July 1990—perhaps 300,000 in the workforce and 600,000 dependents. With the Gulf crisis, many of these people have returned to Jordan, including quite a few who never expected to live there and who had kept relatively few ties. As of June 1991, there are still probably 600,000 Jordanian passport-holders in the Gulf countries, including Iraq. Data cited by Jordanian officials and commentators frequently are vague about the number of Jordanians living abroad, counting some of them but including others in the category of Palestinians. Unless otherwise noted, the data on Jordan used here exclude Jordanian-passport holders who do not live in the East Bank.

Jordan's natural population growth—that is, births and deaths, as distinct from total growth including immigration and emigration—is around 3.0 percent per year. The growth of the labor force in turn depends upon the increase in the population between the ages of 18 and 65, an age cohort which is growing at a faster rate—4.5 percent per year—than the overall population. For the last forty years, the kingdom has been unable to create jobs quickly enough to match its population growth. A chief alternative has been emigration, which absorbed half of Jordan's labor force growth between 1970 and 1985. At the same time that many Jordanians have emigrated in search of higher-paying jobs abroad, as many as 200,000 foreigners—mostly Egyptian and South or East Asian—have moved into Jordan to fill lower-paying jobs.

The political climate for Jordanian and Palestinian laborers in the Gulf countries deteriorated after 1980 (as lower oil prices led to cutbacks in the Gulf) and then changed radically after King Hussein sided with Iraq during the Gulf crisis. The Gulf states are by no means dependent on specifically Jordanian labor and can draw on a readily available alternative source of skilled Arabic-speaking workers, namely Egyptians. Thus, in the first six months after the invasion of Kuwait, half the visas issued for work in Saudi Arabia went to Egyptians. Today, thousands of Egyptian doctors, teachers, engineers, and other skilled workers would like to go to the Gulf and, to the delight of the Gulf states, want only to stay a short while before returning home. In these circumstances, only an optimist can expect any growth in the employment of Jordanians or Palestinians in the Gulf. Indeed, the absolute number employed could well fall further.

Income and Employment

Despite structural rigidities, after 1973 Jordan enjoyed more than a decade of growth, driven largely by aid and remittances, which came to a screeching halt in the late 1980s. Jordan's per capita income (as measured in 1990 dollars) had doubled between 1975 and 1985, from \$1,250 to \$2,500. With the decline in aid and remittances, from an annual level of \$2.0 billion in 1980-86 to \$1.0 billion in 1989, Jordan slid into deep crisis. In response, the government adopted a vigorous adjustment program, with IMF assistance. By the first half of 1990, the economy was on the mend, with real GNP rising 1.5 percent, led by a sharp increase in exports. However, the Gulf crisis has been a sharp blow to Jordan; the economy went into deep decline in the second half of 1990, so that for the year as a whole, notwithstanding growth in the first half, real GNP fell 10 percent.²² Per capita income, adjusted for inflation, fell below the level of 1965.

²²Michel Marto, Deputy Governor of the Central Bank, cited in *Financial Times*, May 31, 1991. Earlier, Finance Minister Basil Jardanah had estimated the decline at 8.2 percent, in the General Budget Statement for 1991, as printed in Foreign Broadcast Information Service, December 6, 1990.

Perhaps the most visible sign of deterioration in Jordan's economic situation, and especially its adjustment program, is unemployment. Reliable data on employment and unemployment in Jordan are not easy to come by. Part of the problem is defining who is a Jordanian; a more significant distortion however, arises from the manipulation of data for political ends. It would appear that in early 1990 between 150,000 and 200,000 foreigners worked in Jordan; about 300,000 Jordanians worked abroad; about 500,000 Jordanians worked in Jordan; and about 100,000 Jordanians were unemployed.²³

The unemployment rate in 1990 was, in other words, 13 percent of the domestic workforce, and 11 percent of the workforce defined as including Jordanians abroad and excluding foreign workers at home. While that is of course a serious problem, it is by comparison about the same as the unemployment rate in Spain. Unemployment today is nowhere near the historic peak of 50 percent reached after the 1970 Palestinian uprising. But the standard of comparison used by ordinary Jordanians was set during the oil boom (1975-1986), during which time prospects were excellent for high-paying jobs in the Gulf as well as for steady advancement in Jordan itself. During this period and since, Jordan had come to rely on foreign workers for most of the low-paid agriculture and service jobs at home with little apparent effect on the employment prospects of Jordanians themselves.²⁴

After the outbreak of the Gulf crisis in August of 1990, some Jordanian officials and commentators acted as if the sky had fallen over Amman. Jordan claimed that it would lose \$1.2 billion on an annual basis from the loss of export markets, transit trade, remittances, and tourism.²⁵ As a prominent

²³The number of unemployed is derived from calculating of the size of the labor force. The figures here imply that 100 percent of the males and 25 percent of the females between 15 and 64 were looking for work, which would seem to be a high estimate. If the actual participation rate is less, then the number of those unemployed is also less.

²⁴In July 1990, the number of Jordanians unemployed was clearly less than the number of foreigners working in Jordan.

²⁵The loss was composed of \$440 million in lost exports, \$350 million in lost aid and Iraqi debt payment, \$400 million extra import costs, \$320 million in lost remittance, \$250 million in lost transit business, and

Jordanian economic commentator pointed out, the claimed loss was about as great as the entire GNP for the last five months of 1990! ²⁶ Foreign estimates were as far off the mark, be it the \$2.2 billion IMF-World Bank estimate, the \$1.8 billion figure from the Overseas Development Institute, Britain's leading development think-tank, or the \$2.1 billion estimate of the U.S. Government. ²⁷

The reality was quite different. ²⁸ The drop in GDP in 1990 was about \$400 million. To be sure, GDP would have grown some without the crisis, and the situation deteriorated further in 1991. Still, the cost of the conflict to Jordan will be around \$500 million per year in 1991-1992.

Meanwhile, the influx of aid from Japan and Europe, plus the government's careful control over expenditures, has meant that Jordan's foreign exchange position actually improved during the crisis. At the end of 1990, reserves were at their highest level in years—\$840 million (about \$500 million if Jordan had paid all its debt arrears as of that date). The Jordanian dinar strengthened on the black market during the crisis, actually rising above its official rate! As of March 1991, Finance Minister Basil Jardaneh estimated foreign aid to the budget at \$1.36 billion in 1991, well above the \$675 million average in 1987-1989. ²⁹ The aid expected for 1991 is equal to \$400 per person, whereas GDP per person is estimated at about \$1,200. In other words, for each dollar Jordanians produce, they

\$230 million in lost tourist revenues (*Middle East Economic Digest*, September 28, 1990, p 24).

²⁶Fahd Fanik, *Al-Ra'y*, November 10, 1990.

²⁷Respectively, Finance Minister Jardaneh, General Budget Statement for 1991, Foreign Broadcast Information Service, December 6, 1990; *Financial Times*, March 5, 1991; and address by James Fall III, Deputy Assistant Secretary of the Treasury for Developing Nations at the Carter Center, November 28, 1990. Both the IMF-World Bank and U.S. estimates are the average for the two years 1990 and 1991.

²⁸Surveys of Jordan's post-war economy in *Middle East Economic Digest*, March 29, 1991 and *Financial Times*, May 31, 1991 .

²⁹The Central Bank of Jordan *Monthly Statistical Bulletin* for May 1991 reports external revenues of the government at \$563 million in 1987, \$681 million in 1988, and \$787 million in 1989.

will receive an extra \$0.33 in aid, three times the comparable figure for Israel.

In sum, while the Gulf War certainly hit Jordan hard, it was not the end of the world. Furthermore, the Jordanian government wisely took vigorous steps to force the economy to adjust to the loss in income, rather than spending money it did not have to subsidize returnees who would eventually need to look for work anyway. The international community then stepped in with generous aid, though little arrived until just before the outbreak of fighting. The end result will be that Jordan will have the resources to improve its infrastructure and, through the private sector, to create additional employment for many of the returnees; however, there is a grave danger that aid monies will instead be wasted on subsidies which exceed the legitimate purpose of cushioning the immediate effects of the crisis on the most vulnerable groups.³⁰ The problems Jordan faces in the 1990s are indeed serious, but they are overwhelmingly due to structural and demographic forces that were in place long before the 1990-91 Gulf crisis. That crisis certainly set back the adjustment that the Jordanian economy had been making in order to resolve the looming unemployment problem, but the effects of the war have been generally exaggerated.³¹

³⁰On September 1, 1990, Jordan introduced comprehensive rationing at subsidized prices of sugar, rice, and powdered milk, with amounts above the ration available at prices set on a cost-plus formula. Expenditures on these subsidies and on the wheat subsidy were \$140 million (4 percent of GDP) in 1990.

³¹One of the most fundamental economic problems facing Jordan has been excessive regulation, which has impeded the flexibility needed for growth. For instance, in 1985, the government introduced a Cropping Pattern Program which required farmers to obtain licenses to grow each kind of vegetable on irrigated land. The aim was to encourage production of cereals instead of vegetables—an uneconomic proposition, given that Jordan can import cereals at low cost while producing high-value-added vegetables during the winter season when prices are highest in European markets. While the program was formally abandoned in 1989, the government has maintained a series of similar policies designed to artificially stimulate cereal output. Another example of the excessive controls that bedevil the Jordanian economy is the extensive price controls, that cover restaurant meals and many foodstuffs.

Jordan Per Capita GNP



Trade Flows

In 1989, 64 percent of Jordan's exports were fertilizer and fertilizer inputs (phosphate and potash).³² These exports go mostly to distant markets in Europe and Asia and would be little affected by any peace accord. However, the best prospects for growth in Jordanian exports are in products other than fertilizer: vegetables (5 percent of 1989 exports), textiles and clothes (4 percent), medical products (6 percent), cement and dairy products (each 2 percent). Before the Gulf War, agricultural products went mostly to Persian Gulf countries. Roughly half of the other exports went to Iraq, which frequently paid above market price partly for political reasons, e.g., as a means of offsetting the problems created for Jordan by the debt the Iraqis had run up in the mid-1980s, a debt which they were slowly paying off. Jordanian businessmen interviewed for this study in the summer of 1990 saw the Arab world as the natural growth market for these exports. They were generally less sanguine about Jordan's ability to compete in other markets against similar products being exported from newly industrialized countries like Taiwan or Malaysia.

Two-thirds of Jordan's imports in 1989 were fuel (17 percent), raw materials for industry (23 percent), and machinery and other capital goods (26 percent). Jordanian businessmen have been generally skeptical that Israel could compete with other suppliers on fuels and other raw materials, nor have they thought that Israeli machinery would be particularly attractive to potential customers. Israel has been seen, rather, as primarily a potential supplier of consumer goods, which currently make up the remaining one-third of Jordan's imports.

Israeli data show that Jordanian sales to the West Bank and Gaza in 1988 were \$10 million and purchases were \$52 million,³³ which would be the equivalent of 1 percent of Jordan's exports and 2 percent of its imports. Jordan treats this commerce as internal trade but requires permits, which also serve to protect Jordanian producers (especially in agriculture) and to prevent indirect entry of Israeli products. The

³²Central Bank of Jordan, *Monthly Statistical Bulletin*, various issues. Trade data cited here exclude re-exports and imports for re-export.

³³*Statistical Abstract of Israel 1989*, p. 709.

requirement that Israeli raw materials not be used in goods shipped to Jordan severely limits this trade; importing materials through Aqaba requires paying Jordanian as well as Israeli customs, plus paying higher shipping and handling costs.

III WATER

Before going on to examine the various economic options that may be generated by a peace process, it is worthwhile to discuss the water situation in the region, a concern which runs through any discussion of the economics of a peace process, but, as we shall see, does not foreclose any options.¹

A sustainable annual water supply in the region encompassed by Israel, Jordan, and West Bank/Gaza cannot exceed 2.5 cubic kilometers.² Some of that water may be needed to flush out salts, so the exploitable amount may be no more than 2.0 cubic kilometers. The supply can not be readily broken down between the different territories, because any such division requires judgment calls as to how much water from each common resource, such as the Jordan River, "belongs" to the various parties. The most important sources of water for the region are: (1) the Jordan River system, much of which originates in Lebanon and Syria, and its main tributary, the Yarmuk, which gets most of its water from Syria,

¹The role of water in Israel's security calculations is discussed in Ze'ev Schiff's *Security for Peace: Israel's Minimal Security Requirements in Negotiations with the Palestinians*, (Washington: Washington Institute for Near East Policy, 1989) pp. 17-24.

²One cubic kilometer is 810,000 acre-feet. One cubic kilometer per annum is equivalent to 31.7 cubic meters per second.

which together supply about 1.5 cubic kilometers³; and (2) the underground aquifers, most of which are in the West Bank, which provide around 0.7-0.8 cubic kilometers,⁴ mostly from the aquifer that carries water underground to the Mediterranean sea.

At present, throughout the Jordan, West Bank and Israel region, water demand exceeds supply by 20-50 percent. The problem is particularly acute during the summer and during dry years, such as 1991. For the region between the desert and the sea, annual water use is currently about 3.0 cubic kilometers, approximately two-thirds of which is used for agriculture and one-third for all other purposes. The 4.5 million Israelis and Israeli settlers use about two cubic kilometers while the 5.0 million people in the West Bank, Gaza and Jordan use about one cubic kilometer.⁵

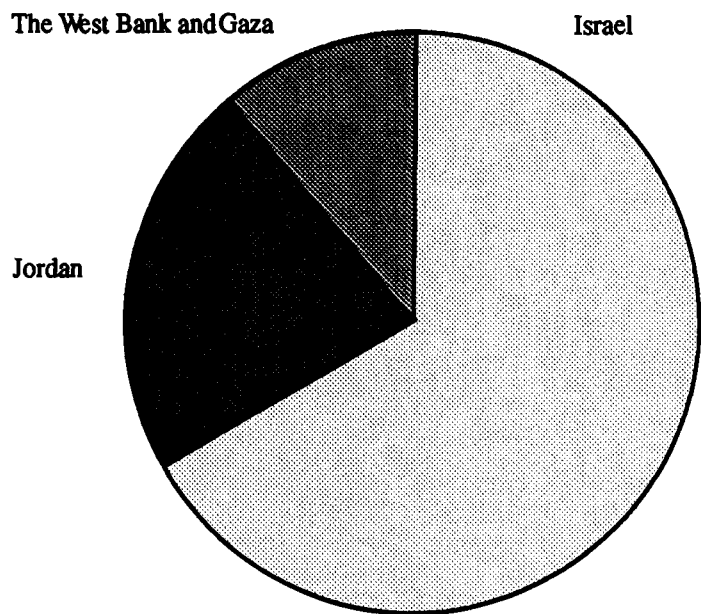
As a result of the imbalance between supply and demand, the area as a whole is drawing down the accumulated groundwater supplies and is not providing enough water to maintain the level of the Dead Sea. Excessive consumption is causing the remaining water to become more saline, as seawater seeps in to replace some of the withdrawn ground water and too little water is available to flush the salts out of irrigated farmland. Because of the water shortage, rationing has been imposed in parts of Jordan and may be introduced in Israel and the occupied West Bank/Gaza as well. The problem of water shortage is likely to become particularly acute in the Gaza Strip by the mid-1990s. Not enough is known about the

³The UN-sponsored Main Report (Charles Main, *The Unified Development of Water Resources of the Jordan Valley*, Boston, 1953) estimated the water potential for development from the Jordan River system at around 1.6 cubic kilometers.

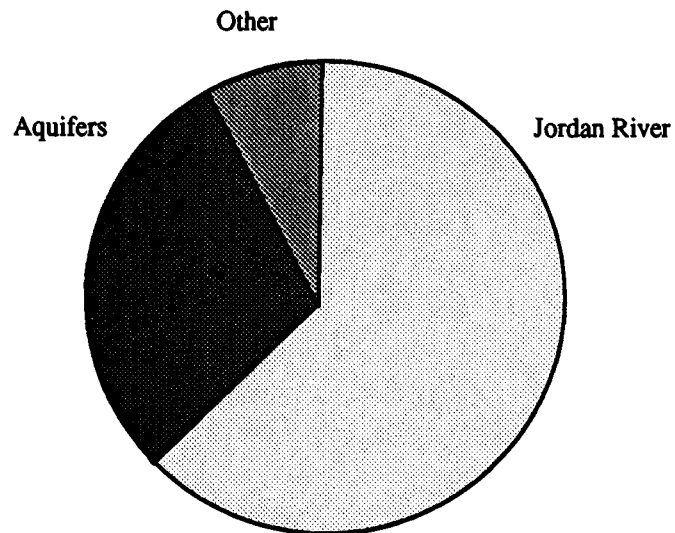
⁴Roffe and Raferty Consulting Engineers, *West Bank Hydrology* (1965), p. 15.

⁵Haim Ben-Shahar, Gideon Fishelson, and Meir Merhav, *Economic Cooperation and Middle East Peace* (London: Weidenfeld and Nicholson, 1989), Chapter 3; and Hisham Awartani, "Agricultural Development and Policies in the West Bank and Gaza" in George T. Abed (editor), *The Palestinian Economy* (London: Routledge Kegan Paul, 1988).

Uses of Water
(Cubic Kilometers Per Annum)



Sources of Water
(Cubic Kilometers Per Annum)



underground water supplies to be sure how long present consumption levels can be sustained before they run out.

The serious problems of water shortage have led to claims that population growth cannot be accommodated, or more specifically, that there will not be enough water to accommodate Soviet immigrants and returning Palestinians. The obvious conclusion would then be that a political settlement must involve steps to limit the inflow of Arabs and/or Jews. These claims are flat wrong: *the water shortage does not mandate any particular settlement of the conflict.*

Water is by no means an insuperable barrier to the region's economic development and population growth. The water balance is primarily an issue of the price at which supply and demand equilibrate. At a higher price for water, the demand would decline and recycling (e.g., of urban sewage) would become more attractive. There is a vast potential for reducing agricultural water demand. At the current extremely subsidized prices for agricultural water, farmers can make a profit from growing cotton, which is basically solid water; its production in a water-short region is a waste of a valuable resource. Ending cotton production would, by itself, be almost enough to bring water demand down to the level of sustainable supply. Furthermore, by charging a reasonable rate for water, authorities could induce farmers to change to less water-intensive crops and to use more water-saving technology.⁶

Extensive agriculture uses roughly ten times as much water as industry for each dollar of income created. The water supply is quite sufficient for 16 million people, which is all the population growth that could be expected for the next 20 years under the highest scenarios for Jewish and Palestinian immigration. The only issue is whether there is enough water to sustain the levels of water-intensive agriculture desired. Over the longer run, a variety of more ambitious water projects

⁶Israeli and Jordanian authorities generally prefer to control water use by administrative orders rather than through price mechanisms. In early 1991, Israel adopted a series of steps to curtail use of consumption by the most water-guzzling crops, e.g., production of irrigated cotton was all but banned. These measures were a response to the poor rainfall in 1990-91, but they are so sensible that they may end up becoming permanent. Jordanian authorities have been pressured by the World Bank to rely more on price increases for irrigated water, but they have also used a variety of administrative measures to reduce water demand.

(such as desalination plants or diversion from large rivers in the region) could be considered if the costs could be kept low enough.

IV THE AUTARCHY AND PRE-1967 OPTIONS

Now we turn to the range of economic options for the future. The extent of economic integration between Israel, Jordan and West Bank/Gaza is the key factor in our analysis.

The first family of solutions, autarchy and a return to the pre-1967 situation, essentially marks off the respective areas from each other for most economic purposes. Though participants to the conflict may find this politically desirable and even rewarding, it will not do much for economic growth and such benefits as it may confer will be largely enjoyed by Israel.

HOUSING

Israel

The economic burden of housing and relocation in the event of a complete separation of the three economies, or at least between Israel on the one hand and Jordan and the West Bank on the other, would fall primarily on Israel. As mentioned earlier, the U.S. State Department recently estimated that currently 200,000 Israelis live beyond the Green Line. We estimate that only 50,000 of them currently live outside East Jerusalem and the surrounding

communities.¹ If Jewish and Arab populations were to be separated as the result of a settlement, the Israeli government will be responsible for relocating between 50,000 and 200,000 people.² This will add to the burden of housing the expected one million Soviet immigrants over the next five years.

West Bank/Gaza

Since Palestinian Arabs are legally not permitted to live within the Green Line without permission, a complete separation between the two economies is not expected to further exacerbate the challenge of improving housing standards for Palestinians in the West Bank and Gaza. The most important variable in this regard is the degree to which Palestinian immigrants will be allowed to enter those territories. If hundreds of thousands of Palestinians returned to the territories, housing these people would place a significant burden on the local economy.³

JOB AND INCOME CREATION

Israel

Israel is by no means dependent on Palestinian labor and its job market would not be deeply affected under a political solution which resulted in economic autarchy. To the contrary, Palestinian labor is a minor factor in the Israeli economy, constituting at most eight percent of the labor force at its peak prior to the outbreak of the *intifadah*. The firing of all Palestinians would not shut down the Israeli economy, though

¹These numbers are sure to change as diplomatic efforts continue, as evidenced by the creation of several new Israeli settlements since peace process discussions resumed in the spring of 1991.

²There is some precedent for relocating Israeli "settlers." As a result of the Camp David agreement between Israel and Egypt, the Israeli government relocated settlers from Yamit and some smaller enclaves in the Sinai desert.

³Jordan's housing situation would, under this scenario, be largely unaffected.

it would create adjustment problems in some select industries, including construction and agriculture. While a complete restriction on all Palestinian workers in Israel could create a labor shortage in the short run, it would not have severe, long-run consequences, given the prospect of one million Soviet immigrants over the next five years. On the other hand, such restrictions would do little to create the jobs needed to absorb the Soviet immigrants and the natural population growth, since Palestinian workers represent less than 20 percent of the jobs needed over five years.

The principal impact for Israelis of a closed economy as compared to an open economy would be a lower rate of growth. Closed economies would foreclose a number of growth opportunities: Markets in other countries, the supplies of goods made by Jordanians and Palestinians at lower cost than Israelis could provide, and complementarity of lower-skilled Arab laborers with highly-skilled immigrants.

West Bank/Gaza

Under the autarchy or pre-1967 scenarios, the prospects throughout the region for absorbing Palestinian population growth, much less finding employment for returnees, would be poor. In addition to the loss of jobs in Israel—which were still at least 50,000 in mid-1991—fewer jobs would be available in West Bank/Gaza because Palestinian businessmen would then have access to fewer markets and would face higher costs. Under full autarchy, it is hard to see how the West Bank and Gaza could maintain their existing employment levels (around 200,000) when the labor force would be at least twice that size. In other words, at least half the labor force would be unemployed.

TRADE AND REGIONAL COOPERATION

Israel

Experience since the outbreak of the *intifadah* suggests that Israel is not dependent on any Palestinian products, and that

therefore a return to the pre-1967 economic relationship with the West Bank/Gaza would have a negligible effect on the Israeli economy, beyond the adjustment which has already begun to take place. Palestinian subcontracting for Israeli firms would be curtailed or eliminated, raising prices for these finished goods in Israel. Israel would also have to forego the revenue from tariffs imposed on imports intended for the West Bank and Gaza, which is perhaps \$100 million per year.

West Bank/Gaza

Limited export opportunities, primarily outside of Israel, and the current "buy Palestinian" policy already serve to promote economic autarchy in the West Bank and Gaza. However, the West Bank and Gaza are not self-sufficient to meet all their natural resource and raw material needs. Promoting individual family farming may help attain food self-sufficiency, but that will deny the economy the ability to pay for imports of industrial products and oil. Because many locally produced goods would cost more than their imported substitutes and because focusing on the home market would require giving up more lucrative opportunities abroad, economic autarchy would severely reduce the standard of living in the West Bank and Gaza.

Given the meager resource endowment of the West Bank and Gaza, it is clear that Palestinians will have to trade with someone in order to promote economic development. The questions are: which products and with whom? Under the pre-1967 scenario, Palestinian trade would be predominantly with or through Jordan. Goods could continue to be traded across the Allenby and Damya bridges, although products destined for countries outside the region would probably have to travel to Amman before being transported by air, or to Aqaba to be transported by sea. The current level of Jordanian protectionism vis-a-vis Palestinian imports suggests that this may be achieved only at considerable cost.

The current trade situation provides some evidence of the economic hardship that would result from permanently separating the West Bank and Gazan economies from Israel. Many economists believe that since the beginning of the *intifadah* in December 1987, Israeli exports to the West Bank and Gaza have fallen by approximately 35 percent. This

decline is due to several factors, the most prominent of which are the fall in Palestinian incomes and buying power as a result of work disruptions on both sides of the Green Line, and a conscious effort by Palestinians to buy locally produced goods where available. On the other side of the equation, Palestinians suggest that it is getting increasingly difficult to sell their goods in Israel and abroad, claiming that the Israeli army purposefully disrupts shipments of Palestinian products through Israel and between West Bank cities.

If Palestinian products are kept out of Israeli and Jordanian markets, Palestinians might try to improve their marketing to Europe. Prior to the outbreak of the *intifadah*, the European Community agreed to facilitate "direct" Palestinian exports to their markets. Under this program, these exports enter the European Community as Palestinian—not Israeli—products. This allows Palestinian exports to compete freely in European markets, as opposed to competing against Israeli products at Israeli ports. This program, which initially received an unenthusiastic reception from Israeli exporters, offers reasonable prospects for increasing Palestinian agricultural exports to Europe. However, a Palestinian economy with few connections to Israel would need access to ports. In the short term, the solution would be to use the port of Aqaba in Jordan. Over the medium term, developing Gaza into a port capable of handling ocean-going vessels might be economically justifiable, though the cost is uncertain. (Some estimates put the cost at as much as half a billion dollars). Be that as it may, in the event that the Jordanian and Palestinian economies were to be separated for political reasons from each other and from Israel, the development of Gaza port would have to be a top priority.

Jordan

For Jordan, the autarchy option would represent little change from current practice, since trade with the West Bank and Gaza is a minor element in Jordanian imports and negligible in terms of Jordanian exports. On the other hand, the pre-1967 solution would pose a challenge to many Jordanian farmers and industrialists, much of whose output would compete directly with products from the West Bank and Gaza. The mood in 1991 among Jordanian officials and

businessmen was supportive of trade barriers to protect Jordanian producers. Such barriers would greatly reduce the advantages, both to Jordanians and Palestinians, of the pre-1967 solution, because they would prevent businessmen on both sides of the Jordan River from profiting from those of their products which offer the best price and quality. Indeed, it is quite possible that Jordanian protectionist policies would convert the pre-1967 option into a *de facto* autarchy.

FINANCING THE PEACE

Israel and Jordan

Neither Israel nor Jordan would find its financial needs changed much by the autarchic or pre-1967 solutions, as compared to the base case of no peace. The question of "peace dividends" and of increased aid in the event of peace are discussed in the following chapter.

West Bank/Gaza

Under the autarchic solution, capital would be needed to reemploy those Palestinians who were working in Israel, build housing for those living in refugee camps, and create jobs and housing for an estimated 650,000 returning Palestinians. Two separate studies, one by Elias Tuma and Haim Darin-Drabkhin, the other by Fawzi Gharaibeh, have estimated the capital needed to establish an autonomous Palestinian economy at about \$10 billion in 1990 dollars, or about five times the current GNP of the West Bank and Gaza.⁴ It is worth noting that this estimate is much less than the estimates of capital requirements in Israel to absorb one million Soviet immigrants. The main reason for this difference is the gap in the standard of living between Israelis and Palestinians. Even so, this estimate does not take into account the significant amount of additional capital that would be necessary to help industrialize the West Bank and Gaza and raise the Palestinian standard of living.

⁴Elias H. Tuma and Haim Darin-Drakin, *The Economic Case for Palestine* (London: Croom Helm, 1978), and Fawzi Gharaibeh, *The Economies of the West Bank and Gaza Strip* (Boulder: Westview, 1985).

A higher and more realistic estimate has been made by George Abed, a Palestinian economist. Abed calculates that \$23 billion would be needed to absorb Palestinian immigrants, reduce Palestinian reliance on the Israeli labor market for employment, and simultaneously increase incomes in the West Bank and Gaza from what he estimates at \$1200 per person per year in 1990 to \$3500 in the year 2000.⁵ Abed breaks down the cost as: \$5 billion for physical infrastructure such as roads, \$5 billion for housing, \$3 billion for social infrastructure such as hospitals,⁶ and \$10 billion for job creation, mostly in industry.

It is hard to see how funds of the magnitude Abed discusses could be raised. He makes the very optimistic assumption of \$12 billion in aid—\$6 billion from Arab countries, \$4 billion from other governments and \$2 billion from international organizations. He also posits \$11 billion from domestic savings and private foreign capital, which is implausible even were the authorities to adopt appropriate policies, especially after the losses sustained by the comparatively better-off Palestinians living in Kuwait.

The most that the West Bank and Gaza could raise over five years from domestic savings would be \$5 billion, including taxes and fees now retained by Israel, the benefits to be reaped from issuing their own currency, national insurance equivalence payments of Palestinians working in Israel and use of a more expansive fiscal and monetary policy, such as large government deficits.⁷ If the new Palestinian authority is

⁵George T. Abed, *The Economic Viability of a Palestinian State* (Washington D.C.: Institute for Palestine Studies, 1990). A declaration of interest: Mr. Abed was Mr. Clawson's supervisor at the International Monetary Fund in the mid-1980s.

⁶\$2.45 billion, which includes \$1.2 billion for health facilities, \$600 million for education, and \$700 million for other, plus contingency, rounded off.

⁷Consumption in 1987 was 89 percent of GNP, i.e., 11 percent was saved. Applied to a \$2 billion GNP, that is \$220 million per year, or \$1.1 billion over five years. But government policies might encourage a higher savings rate. The other factors cited in the text could account for an additional \$2-3 billion over five years.

limited to this internally-generated money, plus some small aid flow, living standards in West Bank/Gaza would drop sharply.

Private foreign capital could supplement local savings in the event of more settled political circumstances and less government regulation, since the region has considerable advantages for attracting private investment. Palestinians and Jordanians hold several billion dollars in Europe and North America, which is a potential pool of funds. Unfortunately, well-to-do Palestinian and Jordanian businessmen nowadays are feeling poor and insecure after the loss of several billion invested in Kuwait. It will therefore be hard to attract them to invest until the political outlook is serene. Furthermore, tapping into Palestinian and Arab money invested in Europe has not been easy in the past. Not only have governments pursued inappropriate policies, but a number of Palestinians have felt that foreign friends should not insist on a profit because they somehow have a duty to invest in the homeland.

The balance, after local savings and private foreign capital, would have to come from aid, whose flows would be determined not by economic, but by political criteria. Yet, as will be discussed further, economic and political problems accompany any substantial increase in aid. Perhaps the ultimate political argument against increased aid in the event of peace is that such aid makes an autarchic solution more attractive as compared with regional cooperation. Should partisans of autarchy discover that peace will bring more aid, which could mitigate autarchy's otherwise daunting costs, they would be more insistent on autarchy and less open to regional openness and economic cooperation.

To summarize, the outlook under the fully autarchic case is bad. If capital flows are low and economies tightly regulated, income levels throughout the region would fall. Israeli incomes would not grow as they might otherwise. Jordanian incomes would continue their gradual decline from their current depressed state toward the Egyptian level, and Palestinians would be trapped at low incomes, dependent on charity to make ends meet.

Autarchy will mean lower incomes than would free trade. However, the costs of the autarchic case would be relatively

low if contrasted not to a fully open economy but to economies that in fact remain under the tight control of regulations, often disguised, such as the economies of Israel and Jordan. In particular, the cost of autarchy to the West Bank and Gaza will be low if the alternative is an economic arrangement that is open only in theory, while kept closed in practice by mercantilist regulations in Jordan and Israel. To be sure, free trade would bring economic benefits to West Bank/Gaza even if all other nations maintained tight barriers; however, experience suggests that few governments have been able to resist the temptation of retaliatory restrictions under such circumstances.

V THE BENELUX AND FREE TRADE ZONE OPTIONS

Nearly all economists agree that the option which would maximize incomes throughout the region would be free trade and free flow of labor and capital between Israel, Jordan and the West Bank and Gaza, i.e., the Benelux option. The remaining question is how much the Benelux option would increase incomes as compared with autarchy, with some economists arguing that the benefits would be small unless current restrictive policies in Israel and Jordan are changed. The West Bank and Gaza would be left particularly vulnerable in a free trade zone in which the two larger economies were protectionist. It is beyond the scope of this study to estimate the quantitative advantage provided by the Benelux option; instead, the discussion focuses on how the advantage would manifest itself, who would gain the most, and what can be done to maximize the benefits.

The fact that the Benelux option maximizes incomes by no means assures that it will necessarily be chosen by the parties: income is not the only desideratum in life. It is quite possible that the peoples of the region would prefer an option with lower incomes but politically preferable, e.g., an economy more independent from neighbors whom one does not particularly like. In the jargon of economists, the "social welfare function" includes many elements, and economists are ill-advised to collapse it to income alone.

HOUSING

Israel

Any political settlement which allows for the flow of labor between the three economies and enables Israelis to live on the West Bank may be expected to reduce the housing burden on Israel proper, and increase the burden on the West Bank and Gaza, depending on the extent of immigration permitted. This is because a Benelux arrangement would not in itself force Israelis living in the West Bank and Gaza to relocate, unlike a trade zone agreement, which almost certainly would. (Any further increase in settlement activity in the West Bank and Gaza would depend on the nature of the political settlement and perceived threats to security).

West Bank/Gaza

Housing considerations for Palestinians can be divided into: relocating Palestinians remaining in refugee camps, providing new housing for natural population growth, and meeting the housing needs of any Palestinians who might return to the West Bank and Gaza as a result of some political settlement (assuming Palestinians do not return in significant numbers to pre-1967 Israel). While the costs of relocating Palestinians currently living in refugee camps may be assumed to be relatively small, the question remains as to who will pay for the relocation effort. In addition to relocating Palestinians living in refugee camps, adequate housing must constantly be provided to meet the natural increase in population at a rate of approximately 50,000 people per year.

The more significant economic hurdle relates to the likely results of easing restrictions on Palestinian immigration into the West Bank and Gaza. Some observers suggest that as many as 650,000 Palestinians might elect to return to the region, while others think many Palestinians might claim passports from any new state but would not reside in its territory. Were 650,000 to return, that would translate into a ratio of roughly one immigrant for every three residents, higher than the one Soviet immigrant for every four Israeli Jews implied by a forecast of one million Soviet immigrants. Immigration at anything like this level would place a significant burden on

the Palestinian economy. The difficulty of absorbing Palestinian immigrants would certainly be exacerbated by weaknesses in the economies of the West Bank and Gaza, and the burden of absorbing these immigrants at an early stage in economic development could reduce income levels significantly.

JOB CREATION

Overall, the benefits of regional cooperation would be greatest if governments were to ease up on the intrusive regulatory schemes to which their economies are currently subjected. In particular, the economies of the area could best adjust to changing circumstances if the Israeli and Jordanian governments took two steps:

First, let small businesses flourish. Throughout the area, the prospects for small business should be excellent—the labor force is highly-educated, many individuals have accumulated sufficient savings to start out on their own, and the experience of work and life abroad gives these potential small businessmen excellent contacts with foreign suppliers and customers. The basic problem is the heavy hand of government rules designed to protect monopolies enjoyed by large, inefficient firms, which are often in the public sector or have powerful political protectors.

Second, let wages fall when needed. Certainly over the medium term, the expansion of employment would create the best conditions for growth, and thus for higher income in the long run. Unfortunately, the governments in the region exercise great pressure to maintain wage levels in the vain theory that this promotes social peace. In fact, artificially high wages make local production uncompetitive on world markets, thus contributing to economic stagnation and the social difficulties that trail in its wake.

Looking to the particular economies involved, greater openness would allow markets to take advantage of the complementarity of the Arab and Jewish labor forces. The human capital of the new, well-educated, Soviet immigrants would be wasted by having them work in construction and factories while Palestinians and Jordanians are forced to remain idle. It will be politically imperative to distribute the benefits from a Benelux-style peace in such a way as to

increase the demand for skilled labor in each community—it would not be acceptable for educated Palestinians and Jordanians to see their job opportunities diminish. But the reality—which may be politically unpalatable—is that Israeli incomes in the Benelux zone will remain at least three or four times that of Jordanians and Palestinians for some time to come.

Israel

A trade zone—that is, the end of the current free flow of labor but preservation of the free flow of goods between Israelis and Palestinians—would create few problems yet open few opportunities for Israelis. Palestinian laborers would experience the greatest losses, while Israel could adjust relatively rapidly to the labor loss, though some sectors, especially construction, would experience high transition costs. The principal positive effect could be new markets for Israeli products; however, as noted below, market opportunities would probably be limited by continuing Arab consumer resistance to Israeli products. The most likely scenario in the event of a free trade zone is for relatively small changes from the present trend: a faster disengagement from use of Palestinian labor and a gradual expansion of trade in Arab markets.

Jordan

The various options for the peace process have much less effect on Jordanians than on Palestinians or Israelis. Even under a Benelux arrangement, it would be unlikely that Jordanians could work in Israel. Demand for labor in Israel is greatest in the central plains, which would be at a commuting distance of some three to four hours from Jordanian population centers. Of more economic significance to Jordan is the possibility of a trade zone, and especially access to the West Bank and Gaza. Jordan can survive without peace or borders open to trade, but the opportunities created by open borders could make the difference between staying at the currently depressed, 1970-level incomes, and recapturing much if not all of the prosperity that was enjoyed at the height of the oil boom.

Under a best case scenario, i.e. large capital flows, open borders, and general economic liberalization, Israel's economy would grow quickly enough to maintain or marginally increase its per capita income despite absorbing a million immigrants; Jordan would climb most of the way back to the prosperity of 1985; and the Palestinians would be able to struggle out of their current depression. That is not a particularly cheery best case. The news that economists have to give the politicians of the region is that bold steps—some of which may be politically painful in the short run—are needed if future growth is to be achieved.

TRADE AND REGIONAL COOPERATION

Trade

Among the several critical elements that would help the West Bank and Gazan economies industrialize and raise living standards is the removal of some of the barriers which face Palestinian industrialization. This would include barriers to imports and exports into and from West Bank/Gaza. Removing these barriers would be central to the "Benelux" scenario.

Israel

The degree to which trade might flow among Israel, the West Bank and Gaza and Jordan within the context of a Benelux-type economic system would vary with the kind of goods traded. Probably the most important variable in this regard is the continued status of the Arab boycott, which encourages and sanctions individual consumer resistance against buying Israeli products. Given the rather long history of animosity between the parties, it seems overly optimistic to expect that a removal of the Arab boycott would have an immediately visible effect on Israeli exports of consumer goods to Jordan. Nonetheless, it is possible that Israeli agricultural exports might experience some growth with increased access to the Jordanian market. There might also be an increase of Israeli exports of components and other manufacturing inputs, to be used in Jordanian production. Even so, some of the Arab businessmen interviewed for this study felt that continuing

animosity towards Israel, plus threats from unreconciled hardliners, will seriously impede sales of Israeli products for the foreseeable future no matter what governments may do. While others thought that Israeli firms could overcome resistance through price discounts, experience on the Egyptian market does not encourage the prospects of Israeli products finding a significant market among Arab consumers.¹

Palestinian exports do constitute a limited, though concentrated, threat to certain sectors of the Israeli (and Jordanian) economies. Left to grow unencumbered, Palestinian exports are sure to cause some dislocation in less competitive labor-intensive industries, but the overall effect would not be too large, given the small size of the West Bank and Gazan economies.

West Bank/Gaza

It is the Palestinians of the West Bank and Gaza who would most likely reap the greatest benefit from more liberal trade in the region. Israel and Jordan are the most logical markets for Palestinian goods, given their proximity and the fact that there is no need to build new ports to facilitate this trade. Easing Israeli trade restrictions on Palestinian products could ease some of the pressure resulting from recent constraints on Palestinians working within the Green Line. Israeli manufacturers might increase their reliance on Palestinian skilled workers for the finishing stages of product manufacture, such as textiles and consumer electronics. In addition, Palestinians might be able to sell more of their agricultural produce in the Israeli market. More importantly, liberal trade between the West Bank, Israel and Jordan would improve Palestinian access to Israeli and Jordanian ports which would serve as the lifeline for any hope of Palestinian trade with markets outside the region.

Jordanian officials and businessmen interviewed in July 1990 cited three factors which would reduce the potential advantages of opening trade relationships with either Israel or the West Bank and Gaza. First, excluding the mineral sector,

¹Some suggest that Israeli products are kept out of Egypt by informal barriers erected by the Egyptian government, not by resistance from Egyptian consumers.

the structure of Jordanian trade has been more competitive than complementary vis-a-vis Israeli and Palestinian production. That is, while Jordan seeks to sell many of the same products which are being exported by Palestinian and Israeli businessmen, Jordan does not purchase many products of the types exported by Palestinians and Israelis. To the extent that competition predominates over complementarity, opening up trade ties may simply divert purchases from one source to another rather than create new trade. But it can be argued that a common market benefits even economies that produce similar products, because the larger market allows the more efficient firms to thrive.

Second, Jordanian producers are often inefficient and rely on extensive government protection. If Jordanian output costs more than West Bank/Gaza and Israeli goods, then opening up trade in locally-produced goods might drive Jordanian producers out of business. On the other hand, some observers have argued that Jordanian producers could out-compete their Israeli counterparts, who also may hide inefficiencies behind the high protective barriers erected by their government.

Third, the importance of the Arab market would make Jordanians reluctant to endanger their position in that market by trading with Israel. Even without a formal boycott enforced by Arab governments, Arab consumers may resist Israeli products and may prefer to trade with firms that are not heavily involved in commerce with Israel. Some Jordanian businessmen feel strongly that their country's trade future lies to the east, not the west, and would therefore hesitate before taking advantage of opportunities for trade with Israel. However, it is not clear how strong Arab consumer resistance would be; price discounts might win out over ideology.

While the establishment of a trade zone alone between Israel, Jordan and the West Bank and Gaza would enhance trade in goods, unlike Benelux, it would restrict the flow of workers between the three economies. Palestinian products would be most affected by such an arrangement, as their products currently face barriers in both Israel and Jordan. A negotiated trade zone would hopefully result in liberalizing trade from the West Bank and Gaza.

Under a trade zone, trade restrictions would be left to competing interests in the three markets. Currently, the Israeli Civil Administration in the West Bank and Gaza and the

Israeli trade bureaucracy largely work to protect the interests of Israeli producers. In order to establish a true trade zone Palestinians must wield more authority over their own commerce.

Restrictions on the "export" of Palestinian workers would result in a substantial restructuring of the West Bank and Gazan economies. The new excess supply of labor would reduce wages in the West Bank and Gaza, and lead to more labor-intensive production, likely increasing the amount of subcontracting which is currently taking place in West Bank/Gaza. Palestinian incomes would also be expected to fall, at least during the period in which the economy attempted to create jobs in order to re-employ these Palestinians. This drop in income and the resulting decline in consumption, especially of imported products, was already evident during the first three years of the *intifadah*.

Jordan

There is no evidence that more liberal economic relations between Israel and Jordan would result in any significant increase in Israeli imports from Jordan, in spite of the fact that there would probably be less Israeli consumer resistance to Jordanian products than Jordanian resistance to Israeli products.² There also do not appear to be many prospects for Jordanian inputs into Israeli goods.

If existing trade relations are any indication, Jordan's reluctance to allow Palestinian products complete and free access into its market is likely to continue. On the one hand, there would probably be a great deal of overlap in the character of the labor markets and the kinds of goods produced in Jordan and in the West Bank and Gaza, raising competitive pressures between the two economies. On the other hand, Palestinians in the West Bank and Gaza might prefer to purchase products made in Jordan, rather than in Israel. Given the differences in the two economies, this might benefit Jordan more than it would hurt Israel.

²Israel is self-sufficient in agricultural products and there would probably be some reluctance to allow Jordanian finished products to compete with higher-wage Israeli goods.

Overall, given the relative sizes of the economies and the long animosity between the parties, it is unrealistic to expect any significant changes in Israeli or Jordanian trade flows as a result of trade liberalization in the region. Nevertheless, such liberalization will be critical to the ability of Palestinians in the West Bank and Gaza to create jobs and sustain a stable economy.

Water Cooperation

In the event of close economic ties among Jordan, Israel, and the West Bank/Gaza, regional cooperation on water issues would seem a natural area for mutual advantage. Many studies have been done of large regional water projects, such as water piped into Gaza and surrounding Israeli territory from the Nile³, a "peace pipeline" from Turkey, and large-scale desalinization plants. Before billions are poured into any of these projects, their economics must be carefully studied, and the forecasts of project costs need to be reviewed. It appears that the cost of the water from some, if not all, of the large projects would exceed their economic value. Furthermore, because consumers now pay a price well below the economic value of the water, such grand projects would require huge subsidies unless water rates were raised sharply. As a means of providing the water for population growth and industry, these projects appear to have much higher costs than such alternatives as recycling urban water or, above all, curtailing the use of highly subsidized water in agriculture. As regards agriculture, few if any crops could be grown at a profit using such high-cost water.

While there is little economic justification for some of the proposed projects—at least for the next decade or two—there are powerful advantages to regional water cooperation on a small scale, as compared to an autarchic approach. Without some cooperative planning, the inhabitants of each territory would be inclined to use water originating in the other. Moreover, each territory would lack incentive to invest in water-saving technologies, the benefits of which would accrue at least in part to the residents of the other territories. In other words, water is

³Water from the Nile is already brought to El Arish in the Sinai, near the Gaza Strip.

another area in which the family of solutions encouraging close economic ties makes people on all sides better off than under the autarchic family of solutions.

There is already a considerable degree of common water use planning in the region. Both Israel and Jordan adhere in practice to the Johnston Plan proposed by an American engineer, with U.S. Government backing, in the 1950s, though there are some important ambiguities in the Plan.⁴ The two sides do cooperate in some water control projects on the Jordan River. This sort of cooperation results in a better situation for each than would unimpeded unilateral action. It is not clear that the same can be said for the water resources of the West Bank and Gaza. The Israelis correctly point out that some centralized controls are necessary to prevent depletion of the aquifer at an even more rapid rate than at present (residents of those areas complain, however, that Israeli settlers are allocated more water per capita than the Arab West Bankers).

Regional water planning must ultimately allocate water on political grounds. There is no scientific nor economic basis for determining a just sharing of water resources. All that can be done by economic science is to identify a broad band within which solutions would benefit each side compared to beggar-your-neighbor competition. Economics cannot ascertain the "right" allocation within that broad band.

FINANCING THE PEACE

No matter the political situation, the financial needs of the region are great: Jobs must be created, along with housing and infrastructure, to accommodate natural population growth and net immigration. In other words, the economies of the area will need large sums for investment, irrespective of the peace process.

Another way to look at the same reality is that the region would benefit from any peace agreement that would reduce the costs of development financing. Economists generally agree that the costs of job creation would be least under the Benelux solution, though they would disagree about the

⁴It is unclear whether it allocates shares in the river's water or absolute amounts, and whether its sharing formula applies to the water flowing by each second or allows for more water to be drawn during periods of peak demand.

magnitude of the difference between the Benelux and autarchy solutions.

The financing requirements for jobs and housing greatly depend on the efficiency with which capital is used, which can vary enormously from state to state. The standard measurement of capital efficiency is the amount of the extra capital needed to create another dollar of output (known as the ICOR, or incremental capital output ratio). Rapidly growing Asian countries have been able to create another dollar of output with only three dollars of investment, while problem-ridden, developing nations in Latin America and elsewhere have required 20 dollars of more of capital to get the same dollar in output growth.⁵ Jordan, Israel, and West Bank/Gaza are all close to each other at around 6 dollars of investment per dollar of growth.⁶ Were Jordan, Israel, and West Bank/Gaza to improve their capital utilization to Asian levels, they could cut their financing needs in half, while if they were to deteriorate to Latin American levels, they would need three times as much financing. In other words, the efficiency of capital can vary so much that it is at least as important a factor as the dollar amount of finance needed. If, for instance, Israel could improve the efficiency with which it uses capital to the level of South Korea, its existing investment funds would be sufficient to house and employ all the expected Soviet immigrants, without one cent of additional aid or foreign borrowing.

One of the surest ways to improve the efficiency with which capital is used is to ease regulations which needlessly tie it up. The tremendous potential for gains in efficiency points to how much Israel, Jordan, and West Bank/Gaza would benefit if their foreign friends insisted on economic reforms instead of merely providing capital that was bound to be used ineffectively, thanks to rules designed to protect one narrow group or another from competition.

⁵According to the World Bank's *Trends in Developing Economies 1990*, the ICOR for 1980-88 was 2.6 in China, 3.1 in Korea, 4.1 in Thailand, 15.2 in Algeria, 21.9 in Venezuela, 25.1 in Mexico, and 118.0 in Yugoslavia.

⁶The 1982-87 ICOR was 5.8 in Gaza and the West Bank, 6.0 in Israel, and 6.5 in Jordan, based on data in the respective Central Bank and government publications on GNP and investment.

Yet, no matter how efficiently capital is used, the financing needed to absorb expected population growth will be large. Some have hoped that financing could come from a "peace dividend", i.e., from lower military spending resulting from peace. In all likelihood peace dividends from an Israeli-Palestinian-Jordanian peace process will be small, because military spending, mostly by Israel, is directed at the threat from well-armed Arab states like Syria, not at Jordan or Palestinians in the West Bank and Gaza. Israel is at any rate unlikely to unilaterally cut its military preparedness in the immediate aftermath of any settlement. Military spending will be cut only over time, with increasing trust and decreasing tension, possibly aided by arms control agreements.⁷ Jordan is unlikely to curtail its military spending, due to its continuing worries over the intentions and much larger military capabilities of its neighbors, particularly Israel, Syria and Saudi Arabia.

Assuming little improvement in capital efficiency in the absence of serious economic reform and given that there will be no significant peace dividend, peace will require large amounts of capital to finance jobs and housing. Some of this financing may be available from foreign private capital. Israelis, Palestinians and Jordanians would all seem well placed to raise private capital abroad, given their ties to sympathizers abroad as well as the large amounts of flight capital of residents that could be reattracted.

However, two fundamental barriers stand in the way of turning this significant investment potential into a reality. The first is political: businessmen hesitate to invest in a region of perceived instability. A lasting and general peace settlement will have much more of an effect on restoring business confidence than a partial agreement that leaves some issues unaddressed and which is not supported by some states in the region. To the extent that the decision to open up the economies to regional cooperation—i.e., the Benelux solution—reflects a political commitment to a lasting and broad peace, then the Benelux solution would be more likely to attract private capital.

⁷Peace will impose some costs on the Israeli military for relocating military bases, but these costs can be absorbed by the existing military budgets during the normal process of maintenance and upgrading of bases in Israel.

Besides the political issue, the second factor influencing private capital flows is economic: how attractive will these economies be for new businesses, leery of the reputation for strangling red tape and for misguided social welfare policies that discourage job-creating investment?⁸ Even in the most peaceful of circumstances, Israel, Jordan, and West Bank/Gaza would not be as attractive to investors as are Eastern Europe or the booming East Asian economies, unless intrusive regulatory policies change.

The combination of the lingering perception of political instability plus the unwillingness of the Israeli and Jordanian governments to quickly change their restrictive policies makes it imprudent to assume that there will be significant inflows of private investment funds into the region over the next few years.

Given these impediments to raising capital, the governments in the area are likely to request more aid to finance peace.⁹ The Camp David precedent, firmly fixed in the minds of regional policy makers, is that U.S. aid would be pitched at high levels for years after any settlement. However necessary this may be for securing the agreement of the concerned governments, it does almost nothing for economic development.

There are two basic problems with increasing aid flows: the first economic and the second political. Aid has been poorly used in the past to subsidize inappropriate investment, failing state companies, and food subsidies, and may have hurt development overall by creating a culture of dependency. When aid is used to subsidize consumption, the result can be that workers scorn the jobs that the economy can provide; witness the complaints about unemployment in Jordan despite the presence of some 150,000-200,000 foreign workers.

⁸As an old Zionist joke has it, "If I invested in Israel I couldn't afford to give charity there."

⁹In addition, there may be a perception among aid donors that there may be a call for aid, unrelated to costs imposed by the peace accord but given to encourage reluctant governments to sign a peace agreement that they do not really like. The demand for this is likely to be highest in the case of a Benelux solution, on the theory that the greatest degree of regional cooperation merits the greatest support from the international community.

In addition to the economic problems of aid, there would be major political problems as well. Israel and Jordan already receive aid vastly in excess of most countries at their income level, and the pressures on Western aid budgets are already great because of the transformations in Eastern Europe. Furthermore, disputes would likely arise over what the aid goes to finance, as signalled by the controversies surrounding the \$400 million loan guarantee from the U.S. for housing in Israel, held up for months over the issue of Jewish settlements in West Bank/Gaza. Finally, Jordan will have problems persuading its traditional patrons in the Arab world to provide any funding, much less increased funding, following the recent Gulf crisis.

One proposal for increasing aid, forwarded by U.S. Secretary of State James A. Baker III, is a multinational development bank for the Middle East, evidently modeled on the existing banks for Africa, Asia, the Americas, and Europe.¹⁰ Implementing the proposal would entail many problems, not least of which would be securing U.S. approval in the absence of Israeli participation, or Arab approval in the presence of Israeli participation. A Middle East Development Bank would at first seem to be an excellent instrument for funding the infrastructure projects that the area badly needs, as well as for promoting regional cooperative investments that no one government would undertake by itself.

Unfortunately, a Middle East Development Bank would be of dubious help to any of the actors in the Israeli/Palestinian peace process:

It is difficult to imagine how such an institution could aid West Bank/Gaza absent an agreement about which state governs that area, for the same reasons that preclude World Bank involvement in West Bank/Gaza. Recipient governments have always insisted that development banks obtain government approval for their loans, and lenders have generally insisted on government guarantees. Even loans from development banks to the private sector still require the approval of the concerned governments.

The Bank would be of little use to Jordan, which is already struggling under a heavy debt burden. Jordan does not suffer from a lack of capital at market interest rates; indeed,

¹⁰*The Washington Post* and *The New York Times*, February 7, 1991.

Jordanians and Palestinians living abroad have several billion dollars that could be invested under proper conditions.¹¹ The Jordanian government has been unable to make efficient use of the billions in aid it has received, which raises serious doubts about whether additional aid would add much to development.

Of the three players, it is Israel which could make most effective use of capital at market rates, in order to put its immigrants to work. The country's new labor, combined with the capital financed by the Bank's loans, would almost certainly generate ample resources to repay the lending. However, there are obvious political problems with a Bank which benefits primarily one side of the Arab-Israeli conflict. In addition, aid funds world-wide are limited, and it is not clear why they should go to Israel, which has a per capita income at least twice the cut-off for World Bank loans. Furthermore, it could be argued that Israel should borrow from international capital markets. While it had a substantial debt problem in the mid-1980s, Israel has not borrowed for five years while its economy has grown, and so its foreign debt is now quite low—\$32 billion, equal to three-fourths of GNP or two years' exports (By comparison, the heavily indebted developing countries have foreign debts equal to more than five years' exports). Finally, if Israel is going to borrow from foreign governments, it would certainly rather borrow from the United States or other friendly governments than turn to an international organization with strong Arab representation.

¹¹ While Jordanian estimates were that as much as \$10 billion was held abroad by Jordanians prior to the invasion of Kuwait on August 2, 1990, the events of the Gulf crisis may have reduced the value of Jordanian-owned assets in Kuwait by several billion dollars.

VI INTERIM STEPS

There is no doubt that peace could lead to economic benefits for the region, and so it would be of great benefit to Jordan, Israel, and West Bank/Gaza to engage in interim steps to improve the difficult and deteriorating economic situation in the region. Moreover, economic cooperation could help move that process forward. It is worth redoubling efforts to promote policies that would improve standards of living without prejudicing the ultimate settlement of the conflict. Not only would such policies make people better off economically, they might also contribute to the peace process (at least at the margins), by showing the benefits of co-operation, improving confidence in the other side's good will, and fostering an environment in which the parties are more likely to compromise than they might otherwise be.

An ideal interim step would bring equal benefit to Jordanian, Israeli and West Bank/Gaza economies. The reality is, however, that the relationship between these three economies is asymmetrical and so, too, would be the benefits of almost any action taken. Because Israel's economy is eight times the size of the other two combined, any policy with an equal dollar benefit to Israel and to its Arab neighbors would have a much larger proportional impact on Jordan and West Bank/Gaza than on Israel.¹ Furthermore, expanding opportunities for trade usually benefits the smaller trading

¹Israel's GNP is estimated at \$45 billion compared to \$5.5 billion for Jordan and the West Bank and Gaza.

partner more, inasmuch as his costs drop while the scale of his operations increases.

Some Israelis and Palestinians might, for their own political reasons, oppose interim measures which would improve the standard of living in West Bank/Gaza. We acknowledge their concerns, but we hope that they can be counterbalanced by the humanitarian interest in allowing Palestinians a better life in the near-term, so long as that can be done in a manner which does not prejudice the ultimate resolution of the conflict.

We recommend seven interim steps which would benefit Israelis, Jordanians, and Palestinians:

- *Develop water policies to reduce depletion of the West Bank aquifers*

Using the aquifers for Israel's water needs is a highly emotional matter, both among Israelis and Palestinians. While the exact magnitudes are subject to considerable debate, all sides agree that the aquifers provide a significant proportion, and perhaps up to a quarter, of Israel's water use. The ultimate disposition of the aquifers cannot be resolved, short of a definite Arab-Israeli settlement.

There is, however, a more immediate problem which could and should be addressed, namely, the overuse of the aquifers. As explained earlier, Israel's annual water usage regularly exceeds the annual natural supply, resulting in a drawing down of ground reserves. Specifically, about 0.8 cubic kilometers of aquifer water is used each year while only about 0.6 cubic kilometers is added to the aquifers. Continued use of the aquifers at the current level would cause serious environmental damage and reduce the reserves available to be drawn upon in years of drought. Furthermore, it is inevitable that someday the draining of the aquifers will have to stop, in that present policies are simply not sustainable. In recent years, the Israeli comptroller general's annual report has emphasized the importance of this issue to Israelis. As these reports show, Israel, as well as West Bank/Gaza, would benefit from implementation of a sustainable water-use plan that ends the draining of the West Bank aquifers.

Israel could end the draining of the West Bank aquifers in a variety of ways. First, and most appropriately from an economic perspective, would be to reduce and eventually end the extraordinary subsidies for agricultural water, by which

farmers receive water at a mere fraction of the cost of providing that water. As a result, farmers have limited incentive to economize water, and are thus encouraged to grow crops—particularly cotton—that would be ridiculously unprofitable if water were priced at its economic cost. Second, water demand could be reduced through administrative measures, such as reducing the acreage that farmers are permitted to plant with cotton. Third, more water could be recycled, especially water from the city sewage systems. Fourth, Israel could consider a large desalination plant. While desalination may be economically unjustified, it would provide the water needed for agriculture at current usage rates at a cost of roughly \$2 billion for the initial plant and tens of millions each year for operating costs. If Israelis wish to continue wasting water on the farms, then they would be well-advised to face up to the cost of this policy rather than hide the problem.

- *Store more Jordan River water during the rainy winter months*

Agriculture in the Jordan Valley, whether in Israel, the West Bank, or Jordan, is constrained by the lack of water during the dry summer months. Agricultural output could be increased if the winter flow in the river were stored for use during the dry season. Of the various ways to accomplish this goal, the most economical by far would be to divert the Yarmuk into the Sea of Galilee (Lake Kinneret) and then pump the water into the Jordanian and Israeli irrigation networks. While such a scheme would provide water at a cost of around \$0.01 per cubic meter, an order of magnitude far less than other proposals, it is unlikely to be politically acceptable.

The solution most politically practical is the proposed Unity (Wahda) Dam at Maqarin on the Yarmuk River, where it forms the boundary between Syria and Jordan. Informal negotiations have been underway between Israel and Jordan about the prospective Unity Dam, so far without results. The Jordanians have been quite unrealistic regarding at least two points. First, they thought they could avoid an agreement with the Israelis on the distribution of the water. That would have been unwise under any circumstances, and was completely unrealistic given that the Jordanians need financing from international aid agencies, led by the World Bank, whose clearly announced and long held policy is to not finance a dam if there are disputes over the rights to its water. This policy

has nothing to do with Middle Eastern politics; indeed, it was adopted after disputes in South Asia. Though all that the Jordanians would have to conclude with Israel is a formal statement of non-objection, they themselves seem offended that the U.S. has not secured a waiver of this requirement.

Second, the Jordanians seem to think that on the merits the dam is none of Israel's business. Yet, the harsh fact is that any accord will have to address some of Israel's concerns. The U.S.-sponsored Johnston Plan of the 1950s provides a framework for sharing the Jordan River waters, but there are still several issues to be addressed. For one thing, it is not clear that all sides have the same understanding of the Johnston Plan or that the Plan's assumptions about water flow are still valid after thirty years of development in the Jordan Valley. While some frame the issue in terms of sharing a percentage of the water, others couch it in terms of sharing an absolute amount, which are two very different things. In addition, incentives must be created for all partners to curtail the salinity of the water, which has become a serious problem. Similarly, procedures are needed to reward those who reduce their call on the water during the season of peak demand.

Failure to compromise will hurt both Israel and Jordan and redound to the benefit of Syria. Most of the Yarmuk water actually originates in Syria, which does not use it, and has agreed to forego its rights to the water in return for the electricity to be generated from the Unity Dam. If that dam is not built soon, Syria may change its mind and use the Yarmuk basin water to develop its southeast.

- *Facilitate foreign capital flow to West Bank/Gaza*

Israel has maintained tight controls on the inflow of funds into the West Bank and Gaza primarily for security reasons, but with the side-effect of discouraging greatly needed aid and investment. Our proposal is that Israel abandon its policy of judging the economic appropriateness of investments and confine its controls to the legitimate security need of ensuring that funds described as foreign capital are not in fact used to subsidize Palestinian groups antagonistic toward Israel.² Note

²Given the climate of opinion in West Bank/Gaza, many of those who would work on any foreign-financed project will be opposed to Israel's policies, if not to the very existence of the state of Israel. The proposal

that the proposal here is about investment projects. Foreign funds for social welfare programs may be more complicated, in that it can be hard to define what constitutes assistance to political opposition. In our proposal, Israel would reserve the right to reject projects on security grounds, but that would be rarely exercised. Aid from foreign governments for investment projects as well as private capital would be actively encouraged.³

Some of the foreign capital would probably go for public works projects like roads and other infrastructure. Our proposal is that Israel take a permissive attitude towards public works, even in cases where the Israeli authorities may happen to think the project is a waste of money. After all, the money is not Israel's, and those spending it should have every right to waste it if they want. Ideally, regional planning councils could be established to improve the use of public works funds, but that may pose political complications. The general principle would be that public works may proceed. Many projects need have no effect on the choice between integration and separation, e.g., many of the roads needed for a separate economy would facilitate labor migration as well. In any case, separate West Bank/Gaza infrastructure leaves open the options for the future of the region. Thus, for example, decisions about whether to build a power grid that would tie into the Israeli electrical net or to build separate but more expensive electrical generating plants should be left to consumers in West Bank/Gaza who will have to bear the costs. It is naive to think that compelling

here is that Israel should make no special requirements of those who work on foreign-financed projects, i.e., anyone permitted to work in the territories should be free to work on a foreign-financed project.

³Most official aid donors, be they foreign governments or international agencies, work with governments, not directly with the recipients. That would not be possible in West Bank/Gaza. On the other hand, many of the donors have been increasing their cooperation with non-government organizations (NGOs) such as international charitable groups. By the terms of this proposal, Israel would freely permit such groups to work in West Bank/Gaza, so long as they maintained full and verifiable accounts to ensure that the funds they received were spent on the specified projects without being diverted to funding political opposition to Israel.

Palestinians to depend upon Israeli electricity is going to reduce their desire for autonomy or independence.

• *Freely license West Bank/Gaza businesses*

Current limitations on business licenses are motivated in large part by misguided mercantilism. To be sure, Israeli firms do profit from their *de facto* monopoly of some products in West Bank/Gaza. However, the profits to Israeli firms are much less than the losses to West Bank/Gaza firms, both because the stifling of competition raises prices and because the would-be entrepreneurs in the territories are prevented from making use of the area's economic resources. Correspondingly, the benefits of freer licensing would be large for West Bank/Gaza and outweigh the small losses to the Israeli economy. In theory, losses to Israeli producers would be offset by benefits to Israeli consumers from the availability of cheaper services and goods in West Bank/Gaza; in fact, consumers would be unlikely to take advantage of the price differentials.

Were licenses freely available, West Bank/Gaza enterprises would be able to serve the local market with a range of small industries and services. The lack of banking services has been a particularly sore point in the West Bank/Gaza and well illustrates the political ill will created by current Israeli policy. Perhaps, Palestinian complaints about the inability to get business loans have been unjustified, and the caution by the banks in the West Bank/Gaza (both Israeli and Arab) have in fact been justified.⁴ But the occupants of West Bank/Gaza

⁴Banks face serious problems in evaluating the risk of lending in West Bank/Gaza, where political unrest makes any business planning speculative. The usual collateral for loans is land, and there is stiff political opposition to seizing and selling land, especially since the legal action would have to go through the Israeli authorities. Furthermore, the two Arab banks—the locally-owned Bank of Palestine in Gaza and the Jordanian-owned Cairo and Amman Bank in the West Bank—have to be cautious because they do not have any reserve bank to which they can turn in the event of a liquidity crunch. That being said, the policies of the banks have been remarkably conservative, with most funds being held in government notes or on international markets rather than being lent back to local business. For more information see UNCTAD, Special Economic Unit, *The Palestinian Financial Sector Under Israeli Occupation*. (New York: UN, 1989).

cannot be sure, and thus attribute their banking problems to political interference rather than to economics.

Much has been done since late 1990 to speed and simplify the granting of licenses, and this progress should be institutionalized and systematized. Otherwise, entrepreneurs will have every reason to fear a reversion to old ways when the political winds shift away from the current enthusiasm for Palestinian development. The bureaucracy in the Israeli economic ministries must begin to reexamine and change their deeply ingrained mercantilist instincts, which have resulted in long delays and have complicated the licensing of West Bank/Gaza businesses.

While opening the Israeli market to West Bank/Gaza products would benefit Israeli consumers, especially because *de facto* monopolies in Israel drive up prices, it would not fit our criteria for an interim measure, because it is consistent with only one long-term solution, namely, integration of the Israeli and West Bank/Gaza economies.

• *Permit a more expansionary fiscal and monetary policy in West Bank/Gaza*

Businessmen and local governments in the West Bank and Gaza have difficulty borrowing; this in turn limits the expansion of industry and the construction of infrastructure. A variety of steps are needed to remedy this situation.

It is necessary to facilitate more local lending from the two existing local banks. These banks need better access to temporary bridging loans from banks; because they lack such access, they are reluctant to commit their own funds. It should also be possible to spread the risk on loans onto business.

Financial markets should be deepened. The West Bank and Gaza are badly “under-banked,” that is, the savings of individuals are not being channeled into financial institutions, with the result that the money sits idle instead of financing commerce, industry and infrastructure. Each effort to create more financial institutions—banks, credit unions, local savings societies, mutual investment funds—requires complicated negotiations about what currency will be used (shekels, dinars, or dollars) and what regulatory rules will apply (presumably some mix of Israeli and Jordanian). Permission was granted in mid-1991 to start three new financial institutions. An even more permissive approach is needed, proceeding from the

supposition that everything is permitted that is not explicitly banned. To the extent that regulation is needed, it could be provided by a neutral body, e.g., a body staffed by the International Monetary Fund with approval from the Israeli and Jordanian central banks.

More varied local government borrowing should be encouraged. The West Bank and Gaza have large unmet demands for the services often provided by local governments, such as roads, schools, and water projects. Borrowing to finance such projects is appropriate, because each project will last for years and costs too much to be paid for in one year. Currently, there are tight restrictions on borrowing, in part a reaction to the various Palestinian “strikes” against paying taxes. The restrictions on borrowing have had little effect on tax payments but have greatly reduced the potential to create jobs and build badly-needed infrastructure. The local governments should be permitted to borrow as they wish and can from local banks, from the sale of bonds to the public, and from aid donors. The only constraint should be that the borrowing be approved by the local population, to avoid the risk that unrepresentative local governments go on a spending binge financed by borrowing.

- *Facilitate West Bank/Gaza exports*

The steps that could be taken by the various actors would be:

Israel: West Bank/Gaza producers should be allowed to choose, at their discretion, between fully participating in Israeli export boards or setting up their own. Such a policy would not hurt Israel, despite exaggerated fears of the competition in citrus and other winter fruits and vegetables. The policy might even benefit Israel by improving access to European markets, given that the Parliament of the European Community has delayed and restricted export credit arrangements with Israel in response to complaints about Israeli obstacles to Palestinian exports.

The U.S.: The U.S. Free Trade Agreement (FTA) with Israel should be extended to include West Bank/Gaza. Currently, the U.S. government charges West Bank/Gaza imports the highest tariff rates charged any country, on the grounds that the West Bank and Gaza are neither part of a recognized underdeveloped nation nor party to the Israel-U.S. FTA. It would do little harm to any U.S. producer to allow West

Bank/Gaza imports into the U.S. duty-free, and the political benefits could be substantial. The U.S. should follow the example of the European Community, which in 1987 accorded to Palestinian exporters the same immunities from tariffs as those granted to Israel and authorized the eleven West Bank/Gaza chambers of commerce to provide certificates of origin.

Arab states: The Arab boycott of Israeli products has placed real burdens on Palestinian products as well. Jordan requires that West Bank/Gaza firms export to the Arab world through firms registered in Jordan; this requirement could be eased by permitting West Bank/Gaza firms to re-register in Jordan. Furthermore, the boycott rules regarding the use of Israeli raw materials need to take account of the reality that West Bank/Gaza producers cannot avoid the inadvertent use of some Israeli materials no matter the producers' intentions.

- *Improve access for tourists*

Easing restrictions on travel between the areas would help social relations which in turn could then lead to better political and economic relations in the region. While it may be possible for tourists to cross the Jordan River from Jordan to the West Bank/Gaza, it is certainly not convenient. The border crossing issue raises many security concerns, but easier arrangements for tour groups would be entirely compatible with strict security requirements. For instance, it should be possible for tour groups to cross without changing buses, and the long delays at the border could be avoided by pre-clearing tour group members for entrance and establishing a special area to inspect tour buses and their contents, with fees charged to cover any cost for this speedier service. Easier crossing procedures are not going to lead to a flood of tourists, and no procedures would make as much difference as an easing of overall tensions in the region. Still, there are some groups that might be attracted to visit the area if they knew they could more easily combine a visit to the holy places with a tour of Petra and Jerash than at present; for instance, more north Europeans might come in the winter, when they could add a cheap week in the sun at Aqaba or Eilat. One Jordanian official estimated that easier tourist procedures could, in calm times, increase the number of European tourists who visit the region in the winter by 10 percent.

CONCLUSION

Economic issues are interwoven into the peace process between Jordan, Israel and the Palestinians. Water rights, trade access, labor mobility and migration are just some of the significant economic issues which must be addressed within the context of **any** peace settlement.

Economic issues will not dictate a peace settlement, nor will their urgency likely propel the process ahead. Rather they serve as the daily reminders of the conflict and the need for a peaceful settlement in the region. The reality is that the conflict is so deep-seated that each side is quite ready to sustain large economic losses, if necessary, rather than sacrifice its own political goals.

It is also possible that addressing some of these issues, through the interim steps outlined in this paper, might create an environment in which to move ahead on settling some of the complex political issues which plague the region. The role that these interim economic measures can play—though limited—is real, in that they can demonstrate the possibility of improving life without sacrificing political aims.

This paper has not exhausted the issue. Rather, we have sought to set forth the major issues and approaches to be borne in mind and, most significantly, have laid out a framework with which the policymaking community can think systematically and constructively about the economic consequences of peace.

TABLE 1: ECONOMIC STATISTICS FOR JORDAN AND ISRAEL

	<u>1968</u>	<u>1973</u>	<u>1980</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
<i>JORDAN</i>									
Population (millions)	1.51	1.90	2.20	2.71	2.82	2.95	3.07	3.10	3.12
<i>Data in Jordanian dinars</i>									
Dollars per dinars	2.80	3.04	3.35	2.53	2.85	2.95	2.69	1.75	1.50
GNP (millions)	166	241	1,190	1,875	2,007	2,038	2,110	2,443	2,467
GNP per capita, 1990 JD	637	522	962	945	974	950	890	863	790
<i>Data in U.S. dollars</i>									
GNP (millions)	465	735	3,991	4,759	5,738	6,017	5,679	4,283	3,717
GNP per capita, 1990 \$	1,528	1,244	2,218	2,480	2,619	2,388	2,046	1,519	1,191
<i>ISRAEL</i>									
Population (millions)	2.80	3.28	3.87	4.23	4.30	4.37	4.43	4.51	4.70
<i>Data in shekels</i> <i>(after 1981: new shekels)</i>									
Shekels/NS per dollar	0.35	0.42	5.12	1.17	1.48	1.59	1.59	1.91	2.01
GNP (billions)	1,375	3,743	99,887	27,112	42,307	53,809	65,071	81,733	99,286
GNP per capita, 1990 NS	12,560	16,701	17,225	19,487	19,840	20,598	21,123	21,024	21,124
<i>Data in U.S. dollars</i>									
GNP (millions)	3,928	8,911	19,493	22,995	28,435	33,736	40,694	42,649	49,244
GNP per capita, 1990 \$	6,969	8,762	6,163	7,696	8,526	9,047	10,168	10,322	10,477

Sources: Central Bank of Jordan, *Monthly Statistical Bulletin* February 1991, and *Yearly Statistical Series 1964-1989*; Israel Central Bureau of Statistics, *Monthly Bulletin of Statistics* April 1991 and *Statistical Abstract of Israel 1989*; International Monetary Fund, *International Financial Statistics*; and authors' estimates.

TABLE 2: ECONOMIC STATISTICS FOR THE WEST BANK AND GAZA

	<u>1968</u>	<u>1973</u>	<u>1980</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
<u>WEST BANK</u>									
Population (thousands)	585	633	718	793	815	837	868	905	909
<i>Data in shekels</i> (after 1981: new shekels)									
GNP (millions)	33	138	5,102	1,128	2,277	2,712	2,350	2,800	2,800
Gross Domestic Product	33	104	3,997	880	1,841	2,065	1,800	2,200	2,200
Income from abroad	0	34	1,105	248	436	647	550	600	600
<i>Data in U.S. dollars</i>									
GNP (millions)	95	328	995	957	1,530	1,700	1,469	1,461	1,388
Gross Domestic Product	95	247	780	746	1,237	1,294	1,125	1,147	1,091
Income from abroad	0	81	215	210	293	406	350	350	297
GNP per capita	162	518	1,385	1,385	1,877	2,030	1,614	1,614	1,527
GNP per capita, 1990 \$	809	1,673	1,695	1,695	2,420	2,379	1,775	1,775	1,527
<u>GAZA</u>									
Population (thousands)	380	387	444	509	527	545	565	594	600
<i>Data in shekels</i> (after 1981: new shekels)									
GNP (millions)	13	68	2,239	483	917	1,223	1,175	1,200	1,150
Gross Domestic Product	13	47	1,459	301	543	723	750	750	750
Income from abroad	0	20	780	181	373	499	425	450	400
<i>Data in U.S. dollars</i>									
GNP (millions)	37	114	436	410	616	766	734	626	570
Gross Domestic Product	37	66	284	255	365	453	469	391	371
Income from abroad	0	48	152	154	251	313	265	234	198
GNP per capita	98	421	982	804	1,169	1,407	1,299	1,053	949
GNP per capita, 1990 \$	488	1,357	1,202	1,138	1,508	1,648	1,415	1,182	949

Sources: Israel Central Bureau of Statistics, *Statistical Abstract of Israel 1989* and *Judea, Samaria, and Gaza Area Statistics* Number 2 of 1988. For 1988-1990, authors' estimates.

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